ISLAMIC FINANCE VERSUS CONVENTIONAL FINANCE AND THE TAXATION CONSEQUENCES

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DECLARATION

I, Rabia D. Lall, hereby declare that the work on which this research paper is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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ABSTRACT

The growth of the Islamic finance industry globally has enticed the South African government to propose amendments to the tax legislation to accommodate the principles of Islamic finance with the aim of promoting Islamic finance in South Africa and ultimately to be the leader of Islamic finance on the African continent.

The focus of this research paper is to discuss the underlying principles of Islamic finance and its tax implications for investors and financial institutions. The nature of Islamic financial products is compared to its conventional financial counterpart to identify whether differences exist between Islamic and conventional finance from a tax perspective. The proposed changes to the South African Income Tax Act No. 58 of 1962 relating to Islamic finance contain deeming provisions to provide tax neutrality between Islamic and conventional finance. It appears that certain international tax issues for Islamic finance have not yet been addressed by the proposed changes and will have to be considered for the tax neutrality to be achieved.

Attention is drawn to Islamic finance tax implications in both the United Kingdom and Malaysia since these countries are considered to be the leading hubs of Islamic finance in Europe and Asia respectively. With reference to the United Kingdom, the tax implications for the selected Islamic financial products are explained with the intention of drawing out differences between the tax treatment in the United Kingdom and South Africa. In addition the tax incentives for Islamic finance in Malaysia are explained together with its impact on the growth of investment in Islamic finance in Malaysia.

ABBREVIATIONS

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions

CFM: Corporate Finance Manual

CGT: Capital Gains Tax

CIS: Collective Investment Scheme in Securities

DTA: Double Taxation Agreement

EM: Explanatory Memorandum

GCC: Gulf Cooperation Council

FSA: Financial Services Authority

HMRC: HM Revenue & Customs

IFI: Islamic Fiqh Academy

IFRS: International Financial Reporting Standards

IFSB: Islamic Financial Services Board

IIFM: Islamic International Financial Market

IIRA: Islamic International Rating Agency

OECD: Organisation for Economic Co-operation and Development

SARS: South African Revenue Services

SPV: Special Purpose Vehicle

TLAA: Taxation Laws Amendment Act

UK: United Kingdom

UK ICTA: United Kingdom Income and Corporations Taxes Act 1988

UK SDLT: United Kingdom Stamp Duty Land Tax

VAT: Value Added Tax

VATA: Value Added Tax Act

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CHAPTER 1

1.1 BACKGROUND

Islamic finance and banking emerged in the 19th century. Attempts were made in the 1960's on a smaller scale to introduce the application of Islamic finance in Egypt (Gooden, 2011:43). In the 1970's, many reputable Islamic banks came into existence (Khan & Bhatti, 2008:709). Three Muslim countries namely, Iran, Pakistan and Sudan transformed their economies to an Islamic basis in the early 1980's (Khan & Bhatti, 2008:709). Islamic finance has been available in South Africa since 1988 through limited avenues. The Islamic Bank was registered with the South African Reserve Bank in 1988, however the bank collapsed by the mid-1990's (Vahed & Vawda, 2008:458). South Africa currently has a fully-fledged Islamic Bank namely, Al Baraka Bank (registered since 1989) which is a subsidiary of the international Al Baraka Banking Group. Recently the well-known western banks (conventional banks) and certain investment management companies have created an Islamic banking window (specialised division within conventional banks) to accommodate the principles of Islamic finance by establishing Islamic financial products.

Muslims constitute almost 23 per cent (early 2011) of the world's population (1.57 billion Muslims) (Hasan, 2012:3). The African continent is home to more than 412 million Muslims (Abrahams, 2011: Online). Although Muslims only form 1.46% of the South African population (according to the 2001 Census), South Africa is aiming to be the central hub of Islamic finance in Africa (Vahed & Vawda, 2008:453). South Africa has sophisticated regulatory and legislative structures, risk management frameworks and compliance structures in order to promote the development of the Islamic financial industry in Africa (Abrahams, 2011: Online). Promoting South Africa as the Islamic financial hub of Africa can have the significant potential of attracting foreign investment into the country. In the year 2011, estimates of the total value of assets managed globally by Islamic financial institutions approximated $1 trillion (Gooden, 2011:43). Global Islamic financial industry forecasts suggests that Islamic banking assets will reach a value of over US $2trillion dollars by 2012 (Nazeer, 2011:60). In the international field, the Islamic financial industry has emerged as the fastest growing financial market (Reyazat, 2011:12). Not only is Islamic finance attractive to Muslims, it also has a wider appeal. In Malaysia, about 80 per cent of *shariah*-compliant investment products are held by non-Muslim investors (Watkins, 2011:32). Islamic finance provides an alternative to clients that prefer a more socially responsible form of finance and investing.

In 2010, the South African government communicated their interest in the development of Islamic finance and shared their vision in promoting South Africa as an Islamic finance hub in Africa. The Minister of Finance, Pravin Gordhan stated: "The development of Islamic finance in South Africa is critical to the expansion of National Treasury's strategy to position South Africa as a gateway into Africa. The treasury envisages South Africa being a central hub for Islamic product development and ensuring rollout of such products into African markets" (Muhammad, 2010: online).

South African tax legislation was amended in 2010 to include certain *shariah* compliant financing arrangements, namely *mudarabah, diminishing musharaka and murabaha* (South Africa, 2010:7). Although the effective date of these amendments coming into force is set at 1 January 2013, the Act which enables this had not been promulgated at time of writing. The aim of these amendments is to provide tax neutrality between Islamic and conventional finance. These changes that are to be brought about indicate that South Africa is committed to promoting Islamic finance. In the Speech by the Minister of Finance Pravin Gordhan - Debate on Taxation Laws Amendment Bills, 2011, the Minister of Finance (2011: Online) indicated that legislation will now also be introduced to add a Government savings instrument that satisfies Islamic principles, known as a s*ukuk* with the hope that the development of this form of financing could encourage new forms of foreign investment beyond traditional Western funding.

Many countries are in the race to emerge as the hub for Islamic finance. Within the geographical domain of the Asian continent, Malaysia is known to be one of the major renowned hubs of Islamic finance as it is one of the first countries to provide an effective balance between both *shariah* compliant and conventional investments (Nazeer, 2012:43) & (Hasan, 2011:68). Malaysia played a key role in pioneering the *Sukuk* and *Takaful* (Islamic insurance) sectors (Nazeer, 2012:44). Malaysia is considered to be the tax haven for Islamic finance (Naim, 2011: Online). The United Kingdom (referred to as 'UK) is one of the European countries that aimed to develop itself as the centre of Islamic finance and investments (Khan & Bhatti, 2008:721). Currently the UK has five authorised Islamic banks and changes have been made to the tax laws to accommodate Islamic finance products with the aim of achieving tax neutrality between conventional finance and Islamic finance (Gooden, 2011:43). UK tax law amendments to level the playing field between Islamic and conventional finance were initiated in 2003; further amendments were made in 2005 and 2006 (Khan & Bhatti, 2008:721). In the Middle East, Bahrain is regarded as the top hub of Islamic banking affairs worldwide (Khan & Bhatti, 2008:710). Qatar is also a well-known Islamic finance hub in the Middle East, both Bahrain and Qatar form part of the Gulf Cooperation Council (referred to as 'GCC') countries[1] (Khan & Bhatti, 2008:710 & 713).

A general perception exists that the term 'profit or mark-up' used in the Islamic financial system is simply another term for interest (*riba)*, and therefore Islamic finance does not differ from conventional finance. The term profit is perceived as a facade. This perception could arise from the fact that the cost of the service is close to what the client would pay if interest had to be paid (Dunn & Galloway, 2011:62). Many steps are involved in executing s*hariah* compliant financial products which could also create a perception that the process involved is a subterfuge to keep from paying *riba* (Dunn & Galloway, 2011:62). This study involves unpacking the underlying nature of Islamic financial products to identify if differences exist between Islamic and conventional finance from a tax perspective as interest received is generally taxable (after deducting particular exemptions). Should the perception lurk in the market, South Africa may lag in the advancement of Islamic finance which could ultimately inhibit foreign direct investment particularly from the African continent and the oil rich Arab Gulf countries and impact on the possibility of providing real growth for the economy. Investors may choose their investment products based on the tax effects for them and hence tax implications are an important component of these types of financial instruments. Globally, many countries have started to amend their tax laws to achieve tax neutrality in order to place Islamic financial products on an equal footing with conventional financial products. In addition to achieving tax neutrality, Malaysia has additional tax incentives to promote Islamic finance and the country as an Islamic Financial Centre. In 2007 Malaysia was ranked in 3rd position and the UK was ranked in 8th position in the list of the top countries by value of *shariah* compliant assets (Jung, DiVanna & Shoaib, 2007:4). In view of the fact that countries like Malaysia and the UK have played a

[1] GCC countries include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates (UAE).

pivotal role in the development of Islamic finance and have made amendments to their income tax legislation, these countries have been selected for the purpose of this study. South Africa has introduced proposed legislative amendments to the Income Tax Act No. 58 of 1962 (referred to as 'the SA Income Tax Act') in this area to achieve tax neutrality. The study will investigate whether South Africa has achieved what it set out to achieve as stated in the Explanatory Memorandum in 2010 and 2011, i.e. to place Islamic finance on an equal footing with traditional western finance thereby avoiding a hindrance of investment in the growing Islamic financial market. A further question that arises is whether South Africa should provide tax incentives to attract investment in Islamic finance in South Africa when compared to other countries. This will also be addressed in this study.

1.2 RESEARCH QUESTION

Working on the premise that there is a general perception that there is no definite difference between Islamic and conventional finance and that this may account for the lack of interest in Islamic finance, from a tax perspective, the need arises for clarification of the tax implications of Islamic and conventional finance from an investor's perspective and whether there are differences. This research endeavours to enhance the understanding of the proposed changes to account for specific Islamic financial products in the SA Income Tax Act, to explain the justification of the proposed amendments and highlight similarities and differences of the tax treatment between South Africa, UK and Malaysia. The research questions which were taken into consideration are listed below:

1) To determine if Islamic finance is different to conventional finance:
   a) What is Islamic finance?
   b) What is the nature of Islamic Financial instruments?
   c) What are the differences between Islamic and conventional finance?

2) To analyse the proposed tax legislation in respect of Islamic financial instruments in South Africa and the reasons for the proposed implementation.
   a) What are the implications of the proposed tax legislation of Islamic financial instruments in South Africa?

3) To analyse the tax implications of Islamic financial instruments in the UK and the tax incentives offered in Malaysia.

4) How do the tax implications of Islamic financial instruments in the UK and Malaysia compare with those to be introduced in South Africa?
   a) Are the tax implications of Islamic financial instruments in South Africa different to the UK and Malaysia and should South Africa have incentives to promote Islamic finance in South Africa?

1.3 THE METHODOLGY

The structure of the research paper is based on the doctrinal methodology. Doctrinal research addresses the law on a particular issue and deals with analysis of relevant legal doctrine (Razak, 2009:20). The research paper firstly explains the principles of Islamic finance and identifies the differences to conventional finance. Relevant literature obtained from articles, journals, books and websites will be referred to. Secondly the research paper will focus on the proposed amendments relating to Islamic financial products in the SA Income Tax Act. A literature review will be undertaken of the relevant proposed sections and paragraphs in the SA Income Tax Act; the 2010 and 2011 Explanatory Memorandum on the Taxation Laws Amendment Bill; books; journals and articles that are applicable to the selected Islamic financial products. Finally, two countries were selected in order to analyse the tax laws that are relevant to Islamic finance in those countries. UK and Malaysia were selected since these countries are considered to be the leading countries in Islamic banking and finance and are regarded as hubs of Islamic finance in Europe and Asia. Another reason why Malaysia was selected is because it has gone beyond the idea of tax neutrality between Islamic and conventional finance and provides tax incentives to promote Islamic finance in the country. A literature review will be undertaken of the relevant taxation legislation in Malaysia and the UK that are applicable to the selected Islamic financial products. The data used in the literature review will be accessed from websites (including government websites) and existing databases.

1.4 LIMITATIONS OF SCOPE

Even though there are various Islamic financial instruments available internationally, the scope of this study addresses Islamic financial instruments offered in South Africa. The South African market currently offers Islamic financial products known as: *Murabaha; Diminishing Musharaka; Mudarabah* and *Takaful*. Islamic insurance known as *Takaful* is specifically excluded since the proposed changes to the Income tax legislation does not refer to this type of product. However, this study will cover the Islamic financial product known as the *Sukuk Ijarah* (proposal by the South African government to issue a *sukuk*).Well known Islamic financial hubs, include Arab countries such as Qatar & Bahrain. Nonetheless the nature of these countries income tax legislation is incomparable to South Africa and is therefore excluded from the study. Differences of opinion may exist between scholars in terms of what makes a product *shariah* compliant, however the research is not aimed at concluding whether a product is *shariah* compliant or not. The purpose of this study is also not to investigate the creation of the products themselves. For the purposes of this study the tax implications are analysed for the selected products that are marketed as *shariah* compliant. Whether a marketed product is *shariah* compliant or not is the subject of a further study.

1.5 WAY FORWARD

The structure of the research paper is as follows:

Firstly in chapter 2, the principles of Islamic finance are described to provide background and understanding to Islamic finance. Chapter 2 further provides the nature of the selected Islamic financial instruments which are then compared to its conventional finance counterpart with the aim of identifying underlying differences between the two finance options. The main focus of the research paper is discussed in chapters 3 and 4. Chapter 3 focuses on the proposed amendments relating to Islamic financial products in the SA Income Tax Act with the aim of determining whether the proposed tax amendments accommodates Islamic finance and whether it aligns to the tax treatment of conventional finance. In chapter 4 the Islamic finance tax legislation in the UK and Malaysia are analysed for the selected financial instruments in comparison to the proposed tax legislation in South Africa to determine whether South Africa's proposed tax amendments is on par with other countries that have already amended their tax laws to accommodate the principles of Islamic finance.

CHAPTER 2

2.1 WHAT IS ISLAMIC FINANCE?

Islamic finance is a system that provides financial products or services that conforms to *shariah* (Islamic law), known as *fiqh al mu'aamalaat* (Islamic commercial law). Islamic law is derived primarily from the *Holy Qur'an*, the *hadith* and *sunnah*. The *Holy Qur'an* is the religious scripture of Islam which Muslims believe to be the verbatim word of Allah (God) which was revealed to Prophet Muhammed (peace and blessings be upon him). *Hadith* is a narration of an act or saying of the Prophet Muhammed (peace and blessings be upon him). The *sunnah* is the way of life of the Prophet Muhammed (peace and blessings be upon him), his manner of conduct in his daily life and his application and his interpretation by word and action of the message of the *Holy Qur'an* (Gooden, 2011:44). *Fiqh* refers to the human understanding and knowledge of *shariah.*

Trade is permitted in Islam provided it does not violate Islamic law. In comparison to conventional interest-based economics, three aspects are prohibited in Islamic economics: *riba* (interest), *gharar* (excessive uncertainty) and *maysir* (gambling or speculation) (Bassens, Derudder &Witlox, 2010:38). The most significant principle of Islamic finance is that *riba* (interest) is strictly prohibited. This prohibition is explicitly stated in the *Holy Qur'an* in various versus. Chapter 2, verse 275 of the *Holy Qur'an* states:

> "Those that live on riba shall rise up before God like men whom Satan has demented by his touch; for they claim that trading is no different from usury. But God has permitted trading and made riba unlawful."

Interest is defined as a fee paid by a borrower of assets to the owner as a form of compensation for the use of the assets. It is most commonly the price paid for the use of borrowed money or money earned by deposited funds (Wikipedia, 2012). The mere definition of interest indicates that interest in itself does not promote any tangible trading activity thereby hindering economic growth which ultimately results in certain economic ills such as inflation, continued unemployment, widening income gaps etc. (Patel, 2008:41). Although *riba* is strictly prohibited, profit making is permitted in Islam provided it does not violate Islamic law. One of the conditions of earning a profit that is allowable is that the profits must be inclusionary and ethical

(Patel, 2008:41). Since interest and uncertainty are not allowed in *shariah,* Islamic financial products are structured on a basis of the principles of profit and loss sharing, trade and lease arrangements (Australia, 2010:52). Islamic finance is based on the theory of a social order of brotherhood and solidarity, unity and harmony (Almutairi: 2010:25). Both the provider and user of capital are required to assume the risk and rewards associated with the transaction (Patel, 2008:41). Other prohibitions in Islamic law include investments in businesses that engage in gambling or pornography, or the sale or consumption of alcohol and pork (Vahed & Vawda, 2008:453). These prohibitions provide an ethical focus and appeals to the wider ethical investor pool (Australia, 2010:5).

Islamic finance thus may provide an alternative or addition to the conventional banking system. Khan and Bhatti (2008:708), in their research found that globally the Islamic banking and finance industry have made breakthroughs to become a viable and competitive alternative to conventional banking. Based on the recent global economic crisis, what does Islamic finance have to offer? Islamic finance focuses on equity financing and trading in tangible assets together with the prohibition of interest. The sharing of profit and loss system in Islamic finance may provide more stability to conventional financial transactions (Tlemsani, 2010:263).

A Muslim, who aspires to enter the business world and requires finance, while maintaining a desire to ensure submission to his faith, is in a predicament if his only option is conventional finance. In terms of *shariah* a finance provider may simply not lend money and charge interest as interest based financing is prohibited. Conventional finance is based on the system of interest in that there is an interest charge for the use of money lent or interest is receivable from money invested. Interest therefore is one of the major components of conventional finance products. As a consequence of this and in order to attract the Muslim population as clientele a finance provider has to devise new products that accommodate the principles of *shariah*. The most common known *shariah* compliant financing arrangements designed by Muslim scholars and jurists that are offered in South Africa include, *mudarabah, diminishing musharaka and murabaha*.

M*udarabah* is a form of partnership where one partner provides capital and the other provides skills (Patel, 2008:41). The profit ratio is agreed upon prior to the beginning of the business activity (Robbins, 2010:1129). Losses are borne by the investor alone (partner that provides capital).

Diminishing musharaka is a joint ownership of assets, where the buyer purchases units of the other partner over a period of time to acquire total ownership. A m*usharaka* is a partnership to undertake economic activity (Patel, 2008:41).

Murabaha transactions are usually used as a financing option to acquire ownership of assets. The method entails one entity purchasing the asset, adding a fixed mark-up profit and then re-selling the asset. The resale can be an instalment sale (Patel, 2008:41). The profit margin is agreed upon at the time of the original sales agreement (Robbins, 2010:1130).

Sukuk is an Islamic investment certificate where the holders of the certificate share in the ownership of the assets and risk and rewards.

Other Islamic finance products offered globally include: *Ijarah, Salam and Istisna. Ijarah* is comparable to a lease. Robbins (2010:1130), described *ijarah* as: "a contract that involves the lease or transfer of ownership of a service for a specified period in exchange for a pre-arranged consideration." *Salam* is tantamount to a pre-paid transaction, whereby you pay now for a commodity and delivery takes place at a later agreed time (Patel, 2008:42). *Istisna* is mostly used to finance construction and development projects since an *istisna* is a contract where the seller agrees to construct or manufacture the asset to be sold (Gooden, 2011:45).

Globally there isn't one single recognised authority on s*hariah* law (Gooden, 2011:44). This is because there are different schools of law within Islamic jurisprudence and the opinions of scholars can differ (Gooden, 2011:44). There are four different schools of thought namely; Hanafi, Maliki, Shafi and Hanbali. The view of each of these schools of *shariah* is considered to be correct. In Saudi Arabia the interpretation of *shariah* is stricter in comparison to Malaysia, whereas the Gulf States follow a mediocre interpretation (Watkins, 2011:34). The trading of *sukuks* for example is fairly low in GCC countries which primarily adhere to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards while the level of trading in countries like Malaysia is much higher (Kassie, Soomar, Dhai & Dukander, 2012:3). The lack of a unified approval structure regarding *shariah* compliant products could hinder the growth of Islamic finance. Institutions offering Islamic finance usually have Islamic scholars that form their *shariah* board and it is the responsibility of the s*hariah* board to approve the products as being compliant to s*hariah* law (Gooden, 2011:44). The trend in South Africa varies in terms of the composition of the members of the s*hariah* board, for example, the composition of the board of Oasis Group Holdings Limited consists of international scholars whereas the s*hariah* board for 27Four Investment Managers comprises both local and international scholars (27Four Investment Managers: Online) and (Badroen, 2009: Online). Another factor that could hinder the growth of Islamic finance is the shortage of s*hariah* scholars (Robbins, 2010:1143).

Since the development and progress of Islamic finance, organisations have been established to provide guidance to the industry. Bahrain has developed a regulatory institution known as AAOIFI (Khan & Bhatti, 2008:711). AAOIFI was registered in Bahrain in 1991 as an independent international organization and is currently supported by 45 countries and 200 members (AAOIFI: Online). One of the key objectives of AAOIFI is to develop accounting and auditing thoughts and standards pertaining to Islamic financial products offered by institutions with the intention of encouraging the users of the financial statements to invest in Islamic financial products (AAOIFI: Online).

Other recognized institutions that have been influencing the direction of Islamic finance are the Islamic International Financial Market (IIFM), Islamic Financial Services Board (IFSB), the International Islamic Fiqh Academy and the Islamic International Rating Agency (IIRA). The IFSB commenced its operations in 1993 and is based in Kuala Lumpur, Malaysia. The main objective of the IFSB is to serve "as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry" (IFSB: Online). The IIFM was established by entities of various countries namely: Central Bank of Bahrain, Bank Indonesia, Central Bank of Sudan, Labuan Financial Services Authority (Malaysia), Autoriti Monetari Brunei Darussalam and the Islamic Development Bank (based in Saudi Arabia). The International Islamic Fiqh Academy is located in Saudi Arabia and one of its key objectives is to try and find solutions in conformity with *shariah* (Robbins, 2010:1133). The IIRA provides investors with a quality rating as to the level of *shariah* compliance (Robbins, 2010:1134).

2.2 NATURE OF ISLAMIC FINANCIAL INSTRUMENTS

2.2.1 MUDARABAH

Mudarabah is a venture where one party provides capital and the other provides skills (Patel, 2008:41). The capital is provided by the party known as the *"rabb-ul-mal"* to another party known as *"mudarib"* for investing in a commercial enterprise (Usmani, 1998:31). The party that provides capital is an investor on a non-executive basis. The user of the capital is the entrepreneur that provides skills. Providing the capital for investment is the sole responsibility of the *"rabb-ul-mal"* and the *"rabb-ul-mal"* has no authority to participate in the management of the investment which is the sole responsibility of the *"mudarib"* (Usmani, 1998:31). The profit ratio is agreed upon prior to the beginning of the business activity (Robbins, 2010:1129). However, a lump sum amount of any profit cannot be agreed upon (Usmani, 1998:31). Losses are borne by the investor alone (the party that provides capital) and the entrepreneur bears operational expenses. The rationale behind the fact that the losses are borne by the investor is that the *"mudarib"* does not invest any capital (Usmani, 1998:31). The *"mudarib"* loss is thus limited to the fact that his skills and labour was in vain (Usmani, 1998:31). Losses incurred by the "*rabb-ul-mal"* are limited to the initial investment.

Mudarabah is mostly offered by financial institutions as an investment product or transactional account. The investor invests by depositing funds with the financial institution, the financial institution then invests those funds in other *shariah* compliant ventures. The investor is entitled to a return based on the actual return from the funds invested by the financial institution; this return is based on the pre-agreed ratio.

With the conventional finance system, an investor is at liberty to simply invest in for example a fixed deposit and earn interest. The underlying difference is that in Islamic finance money cannot make money in the literal sense.

2.2.2 DIMINISHING MUSHARAKA

The literal meaning of the Arabic word *musharaka* is sharing. In the business context a *musharaka* agreement is a partnership that is entered into to undertake economic activity (Patel, 2008:41). *Diminishing musharaka* involves a joint ownership of assets or a joint commercial enterprise. The share of the one partner (finance provider) is divided into units and the agreement is based on the principle that the buyer purchases units of the other partner (finance provider) over a period of time thus to acquire total ownership of the asset. *Diminishing musharaka* is often used in property financing, venture capital projects and equity finance (Patel, 2008:42)

The initial step in a *diminishing musharaka* arrangement for financing an asset involves a joint ownership of assets. Joint ownership of assets can be created in different ways (Usmani, 1998:59). In property financing, the next step involves the finance provider leasing their share to the client and in return rent is paid to the financier (Usmani, 1998:60). Up to this point the schools of Islamic jurisprudence agree on the permissibility of the underlying transactions (Usmani, 1998:60). There is however differences of opinion between the scholars on the permissibility if the property is leased out to a third party (Usmani, 1998:60). In the final step, the share of the finance provider is further divided into units and the client commits to purchase the shares over a stipulated period of time.

Contingent conditions in an agreement may result in *gharar* (excessive uncertainty*)*, which is prohibited in *shariah.* In order to avoid contingencies in a *diminishing musharaka* agreement for property finance certain conditions are required to be adhered to (Usmani, 1998:62). Firstly the agreement of joint purchase, leasing and sale of the units by the finance provider should not be in one single contract (Usmani, 1998:62). The agreement of joint purchase and leasing may be combined as this is permissible in terms of an *ijarah (lease)* (Usmani, 1998:62). At this stage the client should sign a one-sided agreement to purchase the unit of shares over a specific period and the agreement should stipulate that as the purchase of units takes place the rent payable to the finance provider will be reduced based on the amended percentage of ownership by the finance provider (Usmani, 1998:62). It is further preferred that the purchase of the units takes place at the market value of the property at the date of sale of the unit (Usmani, 1998:62). However, it is also permissible to agree the price of the unit in the sale agreement (promise of purchase) (Usmani, 1998:62).

If a *diminishing musharaka* is utilised for acquiring an asset in the carrying on of business in the form of services the underlying principles are similar to that of property financing mentioned above. In the business entity that provides services, a joint ownership of assets is created (which is permissible as discussed above) between the entity and the service provider. However, with the *diminishing musharaka* where an asset is acquired for carrying on the business of services, no rental will be involved and the income generated by the jointly owned asset, i.e. income received for the services will be treated similar to the rental. The service provider will be entitled to a percentage (based on the percentage of ownership at that stage) of the net income generated from the jointly owned asset. The purchase of units of shares of the finance provider will also be subject to the conditions stipulated above for property financing (Usmani, 1998:63). Furthermore, it is permissible and makes commercial sense that the depreciation of the asset utilised in providing the service should be taken into account in calculating the value of the units of the finance provider to be purchased over a period of time (Usmani, 1998:63).

Where a *diminishing musharaka* is utilised for trade only two components are involved. The first component is a *musharaka (partnership)* to undertake economic activity (Patel, 2008:41). Here two parties contribute capital in a joint enterprise. The second component is similar to property financing where the client purchases units of the financier over a specified period of time. The purchase of units of shares of the finance provider will also be subject to the conditions stipulated above for property financing except that the price of the units cannot be fixed in the 'promise agreement' (sale agreement) (Usmani, 1998:63). One option entails that the finance provider agrees to sell the units at the market value of the business at the day of purchase of each unit such that if the value of the business has increased, the price will be higher and if the value of the business has decreased, the price will be lower (Usmani, 1998:64). Alternatively the finance provider permits the client to sell the units to a third party and simultaneously the finance provider offers a specific price to the client (Usmani, 1998:64). Although both options are allowed in terms of s*hariah*, the second option is not practical to the finance provider (Usmani, 1998:64).

The proportion of profit in a *musharaka* arrangement has to be expressly agreed upon at the time of signing the contract. There are differences of opinions between scholars as to how the profit ratio can be determined (Usmani, 1998:24). Jurists such as Imam Malik[2] and Imam Shafi'i[3], believe that the profit ratio cannot differ from the ratio of capital invested (Usmani, 1998:24). Whereas Imam Ahmed[4] is of the opinion that the profit ratio can differ from the ratio of capital

[2] The Imam of one of the four schools of thought within Islamic jurisprudence namely, Maliki.
[3] *Ibid*, Shafi.
[4] *Ibid*, Hanbali.

contribution provided it is agreed by the partners (Usmani, 1998:24). Imam Abu Hanifah[5] takes an in between view such that the ratio of profit may differ to the ratio of investment, however it cannot apply if there is a sleeping partner. In that case, the share of the sleeping partner cannot be greater than the ratio of his investment (Usmani, 1998:24). There are no differences of opinion between the abovementioned jurists regarding the share of losses (Usmani, 1998:24). Each *partner* shall incur a loss exactly according to the proportionate share of his investment (Usmani, 1998:24).

Objections have been raised about *musharaka* agreements since they could have practical implementation problems in comparison to conventional finance (Usmani, 1998:18). Globally however, contracts have been successfully created on this basis. This is due to the fact that *shariah* has broad principles relating to *musharaka* agreements which can accommodate different forms and procedures, provided the guidelines are adhered to (Usmani, 1998:19).

2.2.3 MURABAHA

Murabaha transactions are usually used as a financing option to acquire ownership of assets. *Murabaha* is a term in Islamic jurisprudence which refers to a sale of a specific commodity wherein the seller agrees to sell to the purchaser for a selling price based on a certain profit added to the cost (Usmani, 1998:65). In financing arrangements this method entails one entity purchasing the asset, adding a fixed mark-up profit and then re-selling the asset. The resale can be at spot (sales price paid in full in one transaction) or an instalment sale (Patel, 2008:41). An instalment sale is referred to as *Bai' Mu'ajjal* and is permissible if the due date for payment is fixed in an unambiguous manner (Usmani, 1998:66-70). The profit margin is agreed upon at the time of the original sales agreement (Robbins, 2010:1130). The key distinguishing feature from a general sale in a *murabaha* agreement is that the seller has to expressly inform the purchaser of the cost to the seller, thereby the purchaser is fully aware of the amount of profit (Usmani, 1998:65). As simple as this may seem, there are also rules in terms of *shariah* that govern sales transactions. According to Usmani (1998:66-70), some basic rules of a permissible sale are:

- "The subject of sale must exist at the time of sale.
- The subject of the sale must be in ownership of the seller at the time of the sale.

[5] *Ibid*, Hanafi.

- The subject of sale must be in the physical or constructive possession of the seller when he sells it to another person.
- The sale must be instant and absolute.
- The subject of sale must be a property of value.
- The subject of sale should not be a thing which is not used except for a haram purpose, like pork, wine etc.
- The subject of sale must be specifically known and identified to the buyer.
- The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.
- The certainty of price is a necessary condition for the validity of a sale and
- The sale must be unconditional."

In the *murabaha* agreement if the client defaults on payment at the due date the agreed price cannot be increased (Usmani, 1998:66-76). The finance provider may however include penalties in the agreement if the client defaults. This aspect is common with conventional financing; however the difference arises in terms of the treatment of the penalty by the finance provider. The finance provider in a conventional finance system will treat the penalty as income, whereas in a *murabaha* agreement the finance provider has to distribute the amount to a charitable purpose. Furthermore, other common conditions that are permissible in terms of the agreement include that if the client defaults on an instalment the full amount outstanding may become due immediately; costs incurred in acquiring the asset may be added to the cost price and security may be requested by the finance provider for the amount owing by the client (Usmani, 1998:71).

Initially *murabaha* was not considered as one of the modes of financing. Some scholars are of the opinion that it should not be utilised as a mode of financing and some scholars believe that the use should be restricted to agreements where the *mudarabah* or *musharaka* are not practical. According to Usmani (1998:72), *shariah* scholars have allowed a *murabaha* transaction provided certain conditions are met. One of the conditions is that the word interest cannot be merely replaced with profit Usmani (1998:73). The drafting of the contracts between the finance provider and the client are critical in the permissibility of the agreement. Since the *murabaha* agreement involves a sale, the principles of a permissible sale as mentioned above have to be adhered to. Furthermore, there has to an underlying asset that is to be acquired. A *murabaha* cannot be entered into to pay for an asset already acquired or for expenses which can be the subject of a loan in the conventional finance system.

In terms of *shariah* one cannot sell an asset that is not owned. In financing arrangements the finance provider generally does not own the asset. The finance provider must therefore own the asset before he sells it to the client such that the finance provider is responsible for the risk. In terms of s*hariah* it is permitted that the client acts as an agent to buy the asset on behalf of the finance provider (Usmani, 1998:73). In this case the client then acts in the capacity of an agent for the finance provider thus the finance provider has ownership of the asset and is responsible for the risk. After this transaction the purchaser purchases the asset from the finance provider. Ownership and risk is transferred to the client once the asset is purchased from the finance provider. It is permissible for the seller (finance provider) to enter into an agreement to commit to sell even though the asset is not in the possession of the seller. For the actual sale however, the asset has to be in the possession of the seller (finance provider) (Usmani, 1998:74). If the original sale was entered into unconditionally but the seller signed a separate and independent promise to repurchase the property, the transaction is considered to be permissible by certain schools of thought (Usmani, 1998:85).

What makes this type of arrangement different to an interest-based transaction? According to Usmani (1998:75), the feature that distinguishes the *murabaha* and makes it permissible is that the finance provider bears the risks and rewards of ownership of the asset until the finance provider accepts the offer of sale from the purchaser. There is a general perception that interest is replaced with profit. The underlying nature involves the finance provider purchasing their assets on a cash basis and selling the assets on credit to the client. The increase in price has been argued more to be equivalent to interest charged on a loan. Usmani (1998:77) argues that according to Islamic principles, money and commodity have different characteristics. Money has no intrinsic value and can be utilised for the acquisition of goods or services whereas commodities have intrinsic value directly. Money is simply a medium of exchange whereas commodities can be of different quality (Usmani, 1998:77). In s*hariah* money and commodities are treated differently. As money has no intrinsic value and is basically a medium of exchange any excess on a loan is not allowed in *shariah*. Commodities are treated differently since they have different qualities. The owner of the commodity may sell at whatever price he wishes to obtain. It is argued that if the seller increases the price when he allows credit to the client it is not prohibited by s*hariah* because the full price is against the commodity and not against the money (Usmani, 1998:79). From this statement it appears that if there are commodities involved the increase in price is a permissible. Usmani (1998:77) however further explains, that although it is true that the seller has increased the price of the commodity based on the time of payment, once the price is fixed it relates to the commodity and not to the time frame and furthermore it can never be increased by the seller. The outcome is such that when money is exchanged for money no excessive amount is allowed however if commodities are sold for money the price agreed upon may be higher than the market price (Usmani, 1998:80). When determining the price of a commodity, the time of payment could be an ancillary factor, however it cannot be the only reason for charging an excess amount in a credit sale. All four schools of Islamic law and the majority of Muslim jurists agree that if a seller determines two different prices (cash price and credit price) for a sale of a commodity, it is permissible in *shariah* for the credit sale price to be higher than the cash sale price, provided that at the time of the actual sale the customer decides on an option (either the cash or credit price) (Usmani, 1998:80). The price is then fixed and cannot be increased for late payment or decreased on early payment (Usmani, 1998:80).

2.2.4 SUKUK IJARAH

Sukuk is an Islamic investment certificate where the holders of the certificate share in the ownership of the assets and risk and rewards. The risk and return associated with the assets belongs to the *sukuk* holder for a defined period. The *sukuk* is commonly dubbed as 'Islamic bonds' which technically they are not. *Sukuk* provides an alternative to conventional financing for Islamic finance providers in a sense that it provides a way of managing liquidity (Usmani, 2009:3). The *sukuk* may be sold when the finance providers are in need of liquidity or purchased when the finance providers have excess liquidity. Islamic finance providers in South Africa currently, like other conventional banks, are required to have a certain percentage of interest-bearing instruments (Kassie, *et. al.*, 2012:3). Due to the fact that the interest received is impermissible the finance providers have to distribute the interest received from these investments to a charitable cause or institution, thus placing Islamic finance providers at a disadvantage. The proposed issuance of *sukuk* in South Africa has the potential to assist with the shortage of *shariah* compliant liquidity management instruments.

There are different types of *sukuk* that are permissible under *shariah.* Fourteen different types of *sukuk* have been classified by AAOIFI. Commonly used *sukuk* structures include the *ijarah, musharaka* and *murabaha.* With the *sukuk ijarah*, the investment certificates represent ownership in leased assets or certificates of ownership of the usufruct of existing assets or the ownership rights in lease rentals. Since the holders are part owners of the assets they become entitled to share in the rental income for a specified period. The process involved in establishing a *sukuk ijarah* involves various steps. The originator transfers ownership of assets to the *sukuk* issuer. These assets have to be s*hariah* compliant. This *sukuk* issuer now owes the originator the value of the assets. The *sukuk* issuer then sells certificates of ownership, which are all of equal value. The funds that come from the sale of certificates of ownership is utilised to pay the originator. The issuer holds title to the assets on the *sukuk* holder's behalf. Simultaneously the issuer will lease back the asset over a specified period of time to the originator whereby rental income will be earned by the issuer. The issuer utilises the rental to pay the investors which are the *sukuk* holders. At the end of the designated time the originator may have the right to buy back the assets from the issuer. The holder then uses the proceeds to pay back the buyers of the *sukuk.*

2.3 DIFFERENCES BETWEEN ISLAMIC AND CONVENTIONAL FINANCE

The underlying difference between the abovementioned modes of financing is that Islamic finance is based on the principles of divine law, while conventional financing is based on manmade principles. In most Islamic financial products the return is based on the investment and the underlying asset and not only on the initial capital outlay.

RIBA (INTEREST)

Riba has been explicitly prohibited in the *Holy Qur'an* in four verses. The impermissibility and the consequences of entering into a transaction that involves *riba* are clear and concise for every Muslim. The prohibition of interest was also practiced in Christianity until recent times (Dunn & Galloway, 2011:51).

Some modern contemporary scholars interpret *riba* only as usury which is known as the amount charged on consumption loans (borrowing money to meet day to day needs) and not interest which is the additional amount charged on production loans (loan for commercial purposes) (Hanif, 2011:167). According to Hanif, (2011:168), the Islamic Fiqh Academy (IFA) Jeddah that represents the collective wisdom of *shariah* experts, have the view that any form of interest is prohibited, whether it is a consumption loan or a productive loan.

With conventional financing interest generally forms part of financing arrangements. Interest is impermissible in *shariah* law since it results in injustice to the creditor or to the debtor (Usmani, 1998:17). In the conventional finance system, an investor earns interest at a specified rate of return irrespective of the actual profit earned or loss suffered. Funds invested by the investors are lent to borrowers who utilise these funds for trade or personal use. The borrowers pay a specified interest rate to the finance provider, irrespective of the profit or loss incurred in the utilisation of the funds. The investor of funds is at a significant disadvantage if the borrower of the funds is significantly profitable. If the investor's investment earned a high rate of profit it is unjust for the investor to receive a small portion of the profit (Usmani, 1998:17). On the other hand if the borrower has incurred significant losses and cannot repay its debt to the finance provider, the finance provider suffers the loss of non-recovery of the loan. According to Usmani (1998:18), interest results in one of the main cause of imbalances in the system of distribution which tends to favour the proverb of the rich get richer and the poor get poorer.

The principles of *shariah* provide clearly that if funds are borrowed by a person or an entity it is permitted in two ways. The first being to advance a loan of funds to assist purely on humanitarian grounds; in this situation no excess amount above the advanced loan amount may be claimed as this would be impermissible (Usmani, 1998:18). The second way is to enter into a profit and loss agreement where the provider of funds incurs profit and bears losses on the utilisation of funds advanced (Usmani, 1998:18). Thus the relationship of an Islamic finance provider and its client is that of partners, investors and entrepreneur, buyer and seller, lessor and lessee.

RISK & REWARD SHARING

In comparison to conventional finance were money is lent with a predetermined rate of return, Islamic finance providers participate in joint ventures or partnerships with their clients. Thus Islamic finance providers share in the direct rewards and risk whereas with conventional finance the reward is based on a rate of return that is not directly linked to the actual risk and rewards of the investment.

ASSET BACKED

In Islamic finance, transactions are backed by assets, no returns are provided purely on the basis of lending cash. With conventional finance, returns can be earned purely by lending of cash.

RESTRICTED INVESTMENTS

With conventional financing profit is maximised with only legislative restrictions. Islamic finance providers likewise aim at maximising profits with legislation restrictions but in addition are also subject to *shariah* restrictions.

GHARAR (EXCESSIVE UNCERTAINTY)

The concept of *gharar* refers to *haram* uncertainty in a contract. It involves an exchange wherein a party stands to be deceived through ignorance of an essential element of the exchange (Almutairi: 2010:xxiv). The wisdom behind the impermissibility of *gharar* in Islamic finance is to prevent contractual disputes from arising. Gambling is considered a form of *gharar* in Islamic finance since the parties are unaware of the result of the gamble, the person gambling is taking a chance and furthermore it provides no purposeful economic action (Almutairi: 2010:xxiv). This prohibition in Islamic finance is in contrast to conventional financial practices that involves speculation and derivatives (Almutairi: 2010:xxiv).

2.3.1 MUDARABAH

With deposits for investment purposes in a conventional financing system the reward is interest. A *mudarabah* arrangement involves a partnership of capital and skill. Therefore the underlying difference for this arrangement between conventional finance and Islamic finance is the manner in which the investor earns a reward for his investment. The reward obtained for investing in a *mudarabah* arrangement cannot be fixed since it's based on profit of the partnership. With the conventional finance system total risk is borne by the finance provider and the total rewards belong to the finance provider after servicing the depositors at a fixed rate of interest. This is different to the Islamic finance system where the depositors share in both the risk and rewards based on the outcome of the investment by the finance provider (Hanif, 2011:169).

2.3.2 DIMINISHING MUSHARAKA

Musharaka is considered an alternative to conventional interest based financing. Due to the underlying nature of a *musharaka* agreement it has far reaching effects on both production and distribution of commodities (Usmani, 1998:17). When raising capital, business ventures such as a partnership or a joint venture can provide an alternative to debt and equity arrangements; although these business ventures may provide the benefit of flexibility it could involve more risk (Australia, 2010:47). The finance provider is a partner to the contract in a *diminishing musharaka* arrangement and is not entitled to a fixed rate of return, nonetheless the finance provider shares in the profit and losses. The finance provider of an interest bearing loan does not incur losses whereas the finance provider in the *musharaka* may incur losses if the joint venture is not profitable (Usmani, 1998:17). The return on a *musharaka* arrangement is based on actual profit earned and not on a fixed rate of return.

From the outset it may appear that there are a number of parallels between a conventional loan and a *diminishing musharaka* arrangement. One may perceive the acquisition of the finance provider share by the client as a repayment of the capital. Another perception is that the amount payable by the client in a property finance transaction, using a *diminishing musharaka* arrangement is similar to interest.

Although this perception might exist there are underlying differences between a conventional loan and a *diminishing musharaka* arrangement. In the conventional finance system interest is levied which is usually determined on the basis of demand and supply of capital, in contrast, in a *diminishing musharaka* arrangement rent for the property is charged which is determined through the demand and supply of a real tangible asset (Hanif & Hijazi, 2010:103). Since the finance provider does not own the underlying assets in conventional financing there is no share of risk and reward of ownership of the asset whereas in Islamic finance the finance provider and the client has joint ownership of the asset and they share the risk and rewards that relate to ownership of that asset. Conventional financing does not provide that the finance provider shares in any losses incurred in the underlying asset whereas in the *diminishing musharaka* arrangement the finance provider will share in the losses of the asset.

In contrast to conventional finance the finance provider in terms of *shariah* is responsible for expenses incidental to the joint ownership of the *musharaka* asset which includes, but is not limited to, maintenance, rates and taxes and insurance in proportion to their respective share of the asset (Hameed, 2007:online). Another difference is that if the client's use of an asset is impaired, for example if the asset is destroyed, the client cannot benefit from the lease and cannot be compelled to continue paying rent (Hameed, 2007: online). With a conventional loan the obligation to repay the debt remains (Hameed, 2007: online).

Amounts payable by a client have to be stated in terms of the agreement to avoid any uncertainty. If uncertainty exists the agreement will not be in compliance with s*hariah* law. In order to accommodate this principle in a *diminishing musharaka* arrangement, the rent payable by the client to the finance provider is fixed for a defined period, usually 12 months. The rent payable in the next period would be determined prior to the commencement of the relevant period (Hameed, 2007: online). At this stage the client is given the option to purchase additional units from the finance provider or alternatively settle the obligation. If the client chooses to purchase additional units from the finance provider it will result in the finance provider's share in the joint ownership of the asset reducing and the lease should continue. This will have a direct impact on the rent for the next defined period.

In contrast to conventional financing if the client wishes to purchase the entire share from the finance provider prior to the agreed date there is no additional cost for early purchase whereas a fee for early settlement may be levied in the early settlement of a conventional loan. Furthermore in conventional financing finance providers simply provide finance and are not generally concerned with the manner of usage of the funds. In contrast the finance provider of Islamic finance must be wary of the reputational risk of providing the finance to clients who intend to use the asset for a purpose that is not s*hariah* compliant (Hameed, 2007: online).

2.3.3 MURABAHA

In the conventional finance system where funds are required to acquire an asset, it is typically financed by a loan. The lender provides the funds and the borrower acquires the asset and is liable to the lender to repay the loan amount plus interest. The lender generally has security over the asset such that consequently if the borrower defaults, the lender can enforce the sale of the asset to recover the funds borrowed. Thus the subject of a conventional finance deal which involves interest is generally money for money whereas under Islamic finance contracts of sale (other than money) finance providers can earn a guaranteed predetermined profit which would be justifiable. The difference in comparison to conventional finance is that the transaction involves that the finance provider participates in the risk of ownership of the asset. Furthermore, in the case of default of payment by the client the price cannot be increased, however a penalty can be raised. The penalty does not represent income to the finance provider and has to be distributed to a charitable cause. Another fundamental key difference is that the intended use of the asset that is supplied by the finance provider cannot be for any type of transaction that will involve going against the principles of s*hariah*, for example the asset may not be used in a business that deals with alcohol.

2.3.4 SUKUK IJARAH

In comparison to a conventional bond which is a pure debt obligation, the *sukuk* represents ownership in the underlying asset. The loan of money, to earn money is the underlying principle in a conventional bond. The *sukuk* provides a potential income stream for the *sukuk* holder. For example the *sukuk* holder of a *sukuk ijarah* will earn an income stream in the form of rental income. A bond may be granted for almost any purpose whereas the *sukuk* has to be issued in compliance with the principles of *shariah.* Expenses related to the asset may be payable by the holder of the *sukuk* instrument. Bond holders however, are not liable for asset related expenses. The price of the *sukuk* depends on the market value of the asset and not on the creditworthiness of the potential bond holder (Kassie, *et. al*., 2012:3). Irrespective of whether the enterprise was profitable or not, conventional bonds guarantee the return of the principal sum when redeemed at maturity. The *sukuk* offers an opportunity for an equitable distribution of wealth since it allows the investors to benefit from the actual profits derived from their share. Thus it promotes the circulation of wealth on a broader scale without limiting it to a few wealthy people (Usmani, 2009:3).

Conventional financial arrangements can either be debt, equity or a combination of both debt and equity. Equity represents capital and a right to share in the profits; debt in broad terms represents a right to have money lent and repaid with interest (Australia, 2010:13). Debt can be raised through a conventional bond. A conventional bond is a method used in conventional finance to obtain funds whereby a company that requires funds will approach investors. These investors are provided with a bond certificate and in return earn a rate of interest. The borrower also commits to repurchase the bond at a specified date known as the maturity date at a stipulated price. With a conventional bond the buyer of the bond (investor) receives guaranteed payments regardless of the performance of the entity that sells the bonds, however the significant difference in comparison to Islamic finance is that with the *sukuk* the periodic payments are dependent on the economic performance of the underlying asset (Dunn & Galloway, 2011:59). Thus the first critical and distinct difference between a *sukuk* and a conventional bond is that *sukuk* holders earn rental whereas a conventional bond will earn interest. Another differential factor is the utilisation of funds, with a *sukuk* the funds raised from the issuance of *sukuk* certificates is invested in an asset whereas in a conventional bond there is no such requirement and the funds can be used as the entity wishes. The *sukuk* holder of a certificate in comparison to the investor or holder of a bond certificate has more transparency in terms of knowing exactly what his funds will be invested in. Furthermore, the *sukuk* is asset backed and the certificates represent an undivided share in the underlying asset whereas a conventional bond is debt security that provides a right to income for the investor (Australia, 2010:52).

2.4 CONCLUSION

Islamic financial products are designed with the aim of providing finance that is compliant with the principles of *shariah.* All finance and business transactions are permissible provided certain principles are not violated. This gives rise to the clear and distinct differences between Islamic finance and conventional finance. The distinctions include impermissibility of interest; prohibition of certain industries; *gharar* (excessive uncertainty) and *maysir* (gambling or speculation). The nature of Islamic financial products is such that it is structured on the principles of trade, profit and loss or lease arrangements. Another key feature in *shariah* is transparency and fairness in dealing in financial transactions and this ensures that the finance providers educate the clients such that they are aware of the nature of the financial transaction that they are entering into thereby making informed decisions. Islamic finance is based on a model that provides security, stability and safety for all parties involved in financial transactions and thus is a viable alternative to conventional finance.

Although Islamic finance is at an embryonic stage worldwide, it is essential for South Africa to amend regulatory structures to attract investment in Islamic finance especially if South Africa wants to establish itself as a hub for Islamic finance within the African continent. South Africa has made proposed changes to the legislation that relate to the tax consequences of Islamic finance (effective 1 January 2013 once the Act is promulgated), with the intention of achieving parity between Islamic finance and conventional finance. The next chapter focuses on the proposed tax legislation for specific Islamic financial products within a South African context to determine whether South Africa will achieve its stated purpose.

CHAPTER 3

3.1 PROPOSED NEW TAX LEGISLATION AND THE REASONS GIVEN FOR ITS INTRODUCTION

Islamic financial products are designed such that they achieve similar effects as conventional finance within the boundary of the main aim of providing finance that is permissible in terms of *shariah*. The legal form of an Islamic financial product is fairly different in comparison to conventional financial products which may result in different tax implications that could place an investor in an Islamic financial product at a disadvantage and could impede the attractiveness of Islamic finance. A number of countries internationally are revising their tax frameworks to attract investment into Islamic financial products. South Africa initially proposed changes to income tax legislation to accommodate Islamic finance in 2010, which is contained in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (referred to as 'EM 2010'). Further proposals relating to accommodating a *sukuk* were brought about in 2011 and are explained in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (referred to as 'EM 2011').

In the EM 2010 (2010: 49) the reason specified for the proposed changes relating to s*hariah* compliant products is to accommodate their concept of form, which currently works against taxpayers that invest or participate in *shariah* compliant products. Without the proposed changes to the legislation investors in s*hariah* compliant products may be deprived of certain tax benefits that are generally available to investors that utilise conventional finance. This results in a tax barrier in comparison to tax cost-effective finance that is available with conventional finance (EM, 2010: 49). It is believed that the tax effect could hinder the growing Islamic financial market which could result in undermining South Africa as a financial centre (EM, 2010: 49).

The reasons for the introduction of a *sukuk* in the South African market are set out in the EM 2011 (2011: 71) which include the fact that Islamic finance, as in the case of conventional finance requires government bonds as a 'risk free' standard, in order to set the pricing for other privately issued Islamic bonds. In addition Islamic finance providers require Government bonds for regulating cash flow and balancing of portfolios (EM, 2011: 71). Another crucial reason for the introduction of a *sukuk* is that the banking regulation in South Africa requires banks to hold a percentage of investments in interest bearing instruments, including Government bonds. In terms of *shariah* this interest earned is impermissible income and has to be disposed of, thus placing Islamic banks at a disadvantage in comparison to competitive conventional banks since it lowers the overall yield of Islamic savings products (EM, 2011: 71).

3.1.1 MUDARABAH

In a *mudarabah* arrangement funds are invested by depositors, who in return share in the profit and loss of their underlying investment (see discussion in 2.2.1 and 2.3.1). This profit will be included in the investors' gross income as defined in section 1 of the SA Income Tax Act. There are no exemptions available as in the case of conventional finance and thus the return is fully taxable in the hands of the investor. With the conventional finance system for a similar investment the depositors that invest their money earn interest on those funds. In terms of section 10(1)(i) of the SA Income Tax Act investors in conventional finance that are natural persons are at an advantage since a portion of the interest is exempt.

According to the EM 2010 (2010: 50), there are proposed qualification criteria for the financial institution to offer a tax qualifying *mudarabah*. The first requirement is that it should be advertised as a *shariah* compliant arrangement. Other requirements are as follows (EM, 2010: 50):

- "Funds must be deposited with a bank by the client;
- The anticipated return in respect of the investment must be based on the time value of the funds deposited by the client (i.e. time-value principles);
- The bank must invest the funds deposited by the client in Sharia arrangements;
- The client must incur the sole risk of loss in respect of the funds invested by the bank in Sharia arrangements; and
- The return in respect of the funds invested by the bank in Sharia arrangements must be divided between the bank and the client on pre-agreed proportions."

The proposed tax relief for individual savings is that any profit earned in a *mudarabah* arrangement will be entitled to the same interest exemptions as conventional finance in terms of section 10(1)(*i*)(xv)(*bb*)(A) and (B) of the SA Income Tax Act.

The rationale behind the exemption is explained in the EM 2010 (2010: 50) as follows: “The *Mudarabah* acts like a partnership in form and in substance while the yield is roughly comparable to interest. Partnership sharing of profits in unequal proportions is common. What is unique about the *Mudarabah* form of financing is client access to *Sharia* underlying compliant profits (usually mirroring interest). This form of relationship is also the most common mechanism that banks use to access retail investors.” Although profit appears to mirror the concept of interest, the profit is based on actual profit earned and not on a predetermined rate. The proposed tax provisions treat the profit earned on a *mudarabah* arrangement in the same manner as interest earned on an investment. The inclusion of section 24 JA (1) and (2)[6] in the Taxation Laws Amendment Act, No. 7 of 2010, (referred to as ‘TLAA 2010’) (2010: 78 & 79) and the amendments made to these sections in the Taxation Laws Amendment Act, No. 24 of 2011 (referred to as ‘TLAA 2011’) (2011: 126) address *mudarabah* arrangements and state that any amount received by or accrued to a client in terms of a *mudarabah* arrangement is deemed to be interest for the purpose of section 10(1)(xv)(bb)(A) and (B), as defined in section 24J (1) of the SA Income Tax Act. Thus the proposal in the EM 2010 provides investors in a *mudarabah* arrangement with the same taxation exemption as available to investors in a conventional finance system.

3.1.2 DIMINISHING MUSHARAKA

A *musharaka* is a partnership, whereas the *diminishing musharaka* is a contract where one party agrees and promises to purchase the other parties proportionate equity share in the contract over a period of time such that the total ownership is acquired (see discussion in 2.2.2 and 2.3.2). The legal form and substance of this arrangement has similarities to a partnership agreement, however where a *diminishing musharaka* arrangement is used for financing, the economic substance of the *diminishing musharaka* arrangement appears to be similar to a debt instrument. If the tax consequences are based on the legal form for a *diminishing musharaka* arrangement utilised as a financing arrangement, each partner will be liable to tax on their share of the profits in contrast to interest on a debt instrument.

The main steps in a *diminishing musharaka* arrangement can be summarised as the following:

[6] Although the effective date of these sections coming into force is set at 1 January 2013, the Act which enables this had not been promulgated at time of writing.

Step 1: The seller sells the asset to the finance provider and the finance provider pays the full purchase price to the seller.

Step 2: The finance provider and the client then enter into a contract to implement joint ownership of the asset with the object of making and sharing profits.

Step 3: The client and the finance provider enter an independent, unconditional promise to purchase the finance providers share in the asset, in the future, within a mutually agreed period. As the client's share increases in the asset, the finance providers share correspondingly decreases by the same amount (Hameed, 2007: online). Thus resulting in the client purchasing all the finance providers units over the agreed period and thereby becomes the sole and exclusive owner of the asset.

Step 4: The finance provider leases its proportionate share in the asset to the client and earns rental. The lease is in existence at least for as long as the finance provider has a share in the property. Alternatively, the finance provider charges a profit on each unit sold.

The result of the steps involved with the joint and cross purchase in the *diminishing musharaka* arrangement can be characterised as ordinary revenue (EM, 2010:54). Tax on income differs between the client and the financial institution, in addition the impact on the purchaser depends on whether finance is required for the purchase of a new asset or whether the financial institution is providing refinancing/project development finance (EM, 2010:54).

Qualification criteria for a *diminishing musharaka* arrangement are set out in the EM 2010 (2010: 54); the preamble provides that the product must be offered to the general public and advertised as *shariah* law compliant and in addition the arrangement must satisfy the following requirements:

- "if the asset is acquired from a third-party seller, the bank and the client must jointly acquire the asset. Alternatively, if the bank provides refinancing or financing for a development project in respect of the land, the bank must acquire an interest in an asset owned by the client;
- the client must purchase all of the bank's proportional interest in the asset previously acquired in terms of the arrangement; and

- the amount paid by the client for the acquisition of the bank's proportionate interest in the asset must be paid over a period of time as agreed to between the client and the bank."

The following scenario will be used in the discussion below:

A client wishes to purchase an asset that costs R2 million by entering into a *diminishing musharaka* financial arrangement with a financial institution. The client and the financial institution commit to jointly acquire the asset. On joint acquisition the client will pay R500 000 and the financial institution will pay the balance of R1.5 million. The client commits to purchase 20% of the financial institutions proportionate share over a period of 5 years, R400 000 will be paid annually by the client to the financial institution.

TAX IMPLICATIONS FOR THE FINANCIAL INSTITUTION

On joint acquisition of an asset, with the intent of resale, the asset will be considered to be trading stock as defined in the SA Income Tax Act (section 22) in the hands of the financial institution. On acquisition the financial institution will qualify for a section 11(a) deduction for its proportionate share in the asset in terms of the SA Income Tax Act. When the client purchases proportionate shares from the finance provider, the amount received by the finance provider will be regarded as 'revenue' in nature and will form part of gross income as defined in section 1 of the SA Income Tax Act, therefore no capital gains or losses in terms of Capital Gains Tax (referred to as 'CGT') will be triggered. Each disposal of the financial institutions proportionate share of interest in the asset is essentially a disposal of trading stock, and thus be treated for tax purposes under section 22 of the SA Income Tax Act. The financial institution will treat units not purchased at the end of a financial period as closing stock (section 22(1) of the SA Income Tax Act) and deduct opening stock of units (section 22(2) of the SA Income Tax Act). Based on these principles the normal tax implications for the financial institution in year one is that the financial institution will be allowed a section 11(a) deduction of R1 500 000. Closing stock of R1 200 000 will be included in income and R 400 000 will be included in gross income. The net effect for each of the five financial years is that the financial institution will be taxed on R 100 000 per annum. These tax implications are the effect of not having specific provisions in the SA Income Tax Act for a *diminishing musharaka* arrangement.

Section 24JA (1)[7] of the SA Income Tax Act defines a *diminishing musharaka* arrangement and no significant changes were made to the qualification criteria as set in out in the EM 2010 (2010: 54). The EM 2010 (2010: 54) states that in a *diminishing musharaka* arrangement the financial institution is essentially engaging in disposing of trading stock, since the assets are purchased with the intention of sale. In order to align the tax treatment of a *diminishing musharaka* arrangement to a conventional loan, the proposed changes in the SA Income Tax Act are such that the mark-up in a *diminishing musharaka* arrangement will be treated on revenue account, however the mark-up will be deemed to be interest and not trading stock. The remainder of the instalment will be a reduction of capital. Section 24JA (5)[8] of the SA Income Tax Act sets out the deeming provisions, that in summary, state that for income tax purposes the financial institutions acquisition of an interest in the underlying asset is disregarded. Section 24JA (6)[9] of the SA Income Tax Act, effectively provides that the amount in excess of the purchase price of the underlying asset that is sold should be treated as interest (as defined by section 24J (1)) income by the financial institution for tax purposes and recognised as being earned on a straight-line basis over a mutually agreed upon period between the financial institution and the client. The proposed SA Income tax treatment for the financial institution will be the same for the provision of finance for a new asset or for refinancing/project development finance. Therefore interest of R100 000 will be included in the financial institutions gross income and the remainder of the instalment (R300 000) will be a reduction of the capital outstanding. Although the net Rand effect may appear to be the same the proposed income tax changes places the tax treatment of a *diminishing musharaka* arrangement on an equal footing with a conventional loan. Furthermore, the proposed income tax changes aid financial institutions in terms of administrative amendments that it would potentially have to make should proposed tax changes not be in place.

The purchase and sale of assets qualifies as a supply of goods by the financial institution in terms of the Value-Added Tax Act no. 89 of 1991 (referred to as 'VAT Act'). Output value-added tax (referred to as 'VAT') will be levied in a *diminishing musharaka* arrangement on the earlier of the date of invoice or the date of payment on the sale of each of the units by the financial

[7] Although the effective date of these sections coming into force is set at 1 January 2013, the Act which enables this had not been promulgated at time of writing.
[8] *Ibid.*
[9] *Ibid.*

institutions of its proportionate share. On acquisition of its proportionate share in the underlying asset, the financial institution is entitled to claim an input VAT deduction. These VAT implications do not arise when a financial institution offers a loan in the conventional finance system. In order to align the VAT treatment of a *diminishing musharaka* arrangement with a similar conventional financial product, the financial institution should be deemed not to be involved in the purchase and acquisition of the asset for VAT purposes and thus simply be treated as providing finance to the purchaser to acquire the asset directly from the seller and in the case of providing finance to the client where the client already owns the asset the client should be deemed not to have disposed of the asset to the financial institution.

The proposal contained in the EM 2010 (2010: 55), includes a deeming provision that applies to the financial institution such that the financial institution is considered not to be involved with the purchase and supply of the goods. Thus in a *diminishing musharaka* arrangement the financial institution, for the purpose of the VAT Act (section 8A (2)[10] in the TLAA, 2010:168)), is deemed not to have acquired the financial institutions proportionate share in the goods and the client is deemed to have acquired the financial institutions interest in the goods equivalent to the amount paid by the financial institution and at the time that the seller divested interest in the goods to the financial institution. The acquisition of an interest in the underlying goods by the financial institution and the resale of those goods to the client are ignored. The mark-up that is received by the financial institution is deemed by section 8A (2) (c)[11] of the VAT Act to be an exempt financial service. This implies that the financial institution is only deemed to finance the acquisition. The similar VAT treatment will be applied where the financial institution acquires an interest in an asset from the client with the purpose of providing finance to that client in a *diminishing musharaka* arrangement. In this instance there is a deeming provision wherein the client shall be deemed not to have supplied an interest in the goods to the financial institution (TLAA, 2010:168).

If the finance required by the client is for fixed property, the financial institution will be liable for Transfer Duty when the financial institution purchases the property and the client will also be liable for transfer duty on the re-sale of the financial institutions proportionate share in the fixed

[10] Although the effective date of these sections coming into force is set at 1 January 2013, the Act which enables this had not been promulgated at time of writing.
[11] *Ibid.*

property to the client (on the same asset) in terms of the Transfer Duty Act No.40 of 1949 (referred to as the 'Transfer Duty Act'). The proposals contained in the EM 2010 (2010: 55) eliminate the duplicate transfer duty as would be the case in a conventional loan for the acquisition of fixed property wherein the client is only liable for Transfer Duty in terms of the Transfer Duty Act. The financial institution once again is deemed in both cases (provision of finance for a new asset and refinancing) not to be involved with the purchase or sale of the property, therefore the financial institution simply acts as a conduit. This means that the proposal contained in section 3A(2)[12] of the Transfer Duty Act, in a *diminishing musharaka* arrangement, is that the financial institution is deemed not to acquire the financial institutions proportionate share in the property or deemed not to have acquired an interest from the client. The provisions in the TLAA 2011 broaden the scope of the deeming provision and the term 'bank' is replaced by the term 'financier'. By alleviating the issue of transfer duty being levied twice on the financing of the same fixed property the Transfer Duty treatment in a *diminishing musharaka* arrangement is on par with finance provided for acquisition of an asset in the conventional finance system.

TAX IMPLICATIONS FOR THE SELLER

The original seller will have CGT implications in terms of the 8th Schedule of the SA Income Tax Act, provided that the asset was held as a capital asset. The tax implications for the original seller in a *diminishing musharaka* arrangement are similar to that of a conventional financing arrangement.

TAX IMPLICATIONS FOR THE PURCHASER (CLIENT)

In a *diminishing musharaka* arrangement the client pays a specified amount over a period of time to acquire the financial institutions proportionate share in the asset. On first glance the rental paid (see discussion in 2.3.2), if incurred in the production of income, may qualify as a section 11(a) deduction in terms of the SA Income Tax Act. Ultimately, the rent is paid by the client to the financial institution for the financial institutions portion of the underlying asset. Where the rental paid is market related, then the rent paid by the client is purely for occupation and the entire rental will be tax deductible provided the requirements for deductions in terms of the SA Income Tax Act are met.

[12] *Ibid.*

However, consideration should be given to what the rental payment actually covers in order to determine whether it qualifies as a tax deduction in terms of the SA Income Tax Act. The fact is that the ultimate owner (client) also has the obligation to purchase the financial institutions share of the asset over a specified period of time. In this case then, the payments made to the financial institution thus in essence covers rental and payment of the financial institutions proportionate share of the asset. Thus in comparison to a conventional tenant the rental in a *diminishing musharaka* arrangement would be higher. The additional portion cannot be classified as rent and may not qualify as a section 11(a) deduction in terms of the SA Income Tax Act.

On a closer analysis, the substance of a *diminishing musharaka* arrangement involves the client paying the financial institution the following: 1. Rental for the financial institutions proportionate share; 2. Payments to purchase the financial institutions proportionate share in the underlying asset. The financial institution in a *shariah* compliant arrangement has to cover certain direct expenses relating to its proportionate share in the asset. In practice in South Africa, the rental due to the financial institution is waived to cover the financial institutions share of the expenses in the underlying asset and only an instalment is paid by the purchaser to the financial institution in order to ultimately acquire the financial institutions proportionate share over a mutually agreed period of time. The instalment then in substance represents a repayment of capital. The amount in excess of the capital portion is the financial institutions profit on the transaction and expense incurred by the purchaser. Another issue with this type of transaction relates to the timing and amount of capital allowances that can be claimed. With conventional finance, on acquisition of an asset the purchaser becomes the owner and can claim capital allowances as a deduction from income and the amount in excess of the capital (interest) if these expenses are incurred in the production of income (within the realm of the provisions in the SA Income Tax Act).

In order to achieve equity in relation to the tax treatment between Islamic finance and conventional finance the EM 2010 (2010: 55) proposes certain deeming provisions for the client. The impact for the client differs depending on whether finance is required for a new asset from a third party or whether the financial institution is providing refinance or project development financing EM 2010 (2010: 55). In the case where there is joint ownership in the asset, the client is deemed to acquire the asset for the amount of consideration paid by the financial institution for the financial institutions proportionate share in the asset. The time of acquisition is similarly deemed to be the same time that the financial institution acquired its ownership interest in the asset from the seller of the asset (EM, 2010: 55). The repayment made by the client will represent part capital and part as a finance charge. The split between the capital and finance charge will be allocated on a pro rata formula, where the amount paid by the financial institution is divided by the total number of instalments agreed upon between the client and the financial institution (EM, 2010: 55). For the purposes of the VAT Act (section 8A(2)[13]), the proposal contained in the EM 2010 (2010: 55), includes deeming provisions that apply if the client and the financial institution jointly acquire the asset. The client is deemed to acquire the financial institutions proportionate share in the asset directly from the seller for an amount equal to the amount paid by the financial institution to the seller and the client is further deemed to acquire the interest at the same time that the seller disposed of that interest to the financial institution.

Similarly, the proposals contained in the EM 2010 (2010: 55-56) also include the impact in respect of the Transfer Duty Act (section 3A(2)[14]). The client once again is deemed to acquire the financial institutions proportionate share in the asset directly from the seller. The amount of the deemed direct acquisition from the seller is deemed to be the amount equal to the consideration payable by the financial institution to the seller and the time is also deemed to be the same time that the seller disposed of the interest to the financial institution, therefore transfer duty will only be payable once by the client. This section alleviates the issue of transfer duty being levied twice on the financing of the same fixed property. An amendment was made to this section in the TLAA 2011 to broaden the scope of the deeming provision and the term ‘bank’ is replaced by the term ‘financier’. On the other hand where the financial institution acquires an interest in an asset that is already owned by the client, the client is deemed not to have disposed of an interest in the asset or acquired any interest therein from the financial institution (EM, 2010: 56).

As the client makes payments to the financial institution a portion of the repayment will be deemed to be a finance charge and not of a capital nature. The basis for the calculation of the revenue portion in both cases is allocated on the basis of the total amount spent by the financial institution divided by the total number of instalments. The finance charge portion is what the

[13] *Ibid*.
[14] *Ibid*.

client can deduct if the expense is a trade expense incurred in the production of income of the client in terms of the SA Income Tax Act. Thus the revenue portion is calculated on the straight line basis. The formula contained in section 24J of the SA Income Tax is not utilised in this section and the rationale for this is that the financial institution's interest in the underlying asset is sold on an annual basis in terms of separate agreements and the net effect of the proposed method is to achieve the same compounding result as section 24J of the SA Income Tax Act (EM, 2011:21). However, financial institutions that recognise income on the effective interest rate method or an alternative method other than the straight line method will have to modify their reporting systems to recognise the income on a straight line method in a *diminishing musharaka* arrangement (Suliman, 2011:92).

For the purposes of the VAT Act (section 8A (2)(*b*)(ii))[15], the proposal contained in the EM 2010 (2010: 55), includes an additional deeming provision that applies if the financial institution acquires an interest from the client (the client is thus the seller and the financial institution is providing refinance of an asset), whereby the client is deemed not to have subsequently acquired the interest in the asset from the financial institution. Thus where the client is the seller the client is deemed to have retained the asset all along.

Similarly, the proposals contained in the EM 2010 (2010: 56) include the impact in respect of the Transfer Duty Act (section 3A(2)[16]) in a *diminishing musharaka* arrangement. The client once again is deemed not to have subsequently acquired the interest in the asset from the financial institution, thus the client is deemed to have retained the asset all along. Thus in the case of refinancing, the client is deemed neither to have ever sold the fixed property to the financial institution nor to have bought it back and therefore no transfer duty will be payable.

Section 24JA(1)[17] of the SA Income Tax Act defines a *diminishing musharaka* arrangement and no significant changes were made to the qualification criteria as set in out in the EM 2010 (2010: 54). Section 24JA(5)[18] of the SA Income Tax Act sets out the deeming provisions, that in summary states for income tax purpose the client is regarded as if it has acquired the full interest

[15] *Ibid*.
[16] *Ibid*.
[17] *Ibid*.
[18] *Ibid*.

in the asset in the case of an acquisition of a new asset and where an existing asset is being refinanced the client is deemed to have retained the full interest in the underlying asset. Overall the deeming provisions contained in the TLAA 2010 and the amendments contained in the TLAA 2011 have the effect of treating a *diminishing musharaka* arrangement on an equal basis with its conventional finance counterpart.

3.1.3 MURABAHA

The economic substance of a cost plus profit sale, i.e. a *murabaha* arrangement to acquire an asset and where financing is required is similar to a conventional loan. However the form of *murabaha* arrangement, when utilised a financing arrangement is different to a conventional loan (see discussion in 2.2.3 and 2.3.3). The EM 2010 thus aims to place a *murabaha* arrangement on equal footing with a conventional loan for tax purposes.

The qualification criteria set out in the EM 2010 (2010: 51) includes that if a natural person requires finance in respect of a *murabaha* finance arrangement the product should be offered by the bank to the general public and should be advertised as a product that is complaint to *shariah* law. Further requirements include the following as per EM 2010 (2010: 51):

- "The asset must be purchased by the bank from a third party for the benefit of the client based on terms and conditions agreed upon between the client and the third party seller;
- The client must acquire the asset from the bank within 30 days after the acquisition of the asset by the bank from the seller;
- The client must agree to pay an amount that exceeds the consideration paid by the bank for the acquisition of the asset from the seller;
- The aggregate amount payable by the client must be based on the time-value of money (i.e. amount paid by bank in combination with duration of the arrangement); and
- The aggregate amount payable by the client must not exceed the amount agreed to when the arrangement is initially entered into."

This type of arrangement can be used by a Collective Investment Scheme in Securities (referred to as 'CIS') as a lender for the acquisition of securities for the benefit of the bank and the qualification criteria are the same as above (EM, 2010:51). In a *murabaha* arrangement the client is acquiring an asset from a third party seller with the financial institution acting as agent (and lender) to facilitate the transaction (EM, 2010:51). In principle the *murabaha* arrangement results in a double sale, the first sale is when the seller sells to the agent and the second sale occurs when the agent sells to the purchaser. The double sale will give rise to multiple adverse tax effects.

TAX IMPLICATIONS FOR THE FINANCIAL INSTITUTION

When a person acquires an asset for resale and the intention of the acquisition is to make a gain by selling the asset in a profit making scheme, the proceeds received for the sale will then be included in gross income in terms of the SA Income Tax Act[19] the transaction is on revenue account. In terms of paragraph (a) (ii) of the definition of "trading stock" in section 1 of the SA Income Tax Act any asset –

> "the proceeds from the disposal of which forms or will form part of his gross income, otherwise than in terms of paragraph (j) or (m) of the definition of 'gross income', or as a recovery or recoupment contemplated in section 8(4) which is included in gross income in terms of paragraph (n) of that definition;"

is regarded as trading stock for purposes of section 22 of the SA Income Tax Act. The financial institution is simply acquiring an asset for resale, thus the asset is considered trading stock in the hands of the financial institution. In terms of the phrase 'received by or accrued to or in favour of a person' in the gross income definition in section 1 the SA Income Tax Act there are two ways in which income may arise in a taxpayer's hands: it may be received by him or it may accrue to him. Gross income arises at the earlier of receipt or accrual. Once the taxpayer becomes unconditionally entitled to receive it, the amount is considered to be 'accrued' (Lategan[20] and Peoples Stores[21]). The proceeds acquired by the bank thus will be included in gross income although the amount received may be deferred. The financial institution will qualify as a VAT vendor in terms of the provisions contained in the VAT Act and will be therefore required to levy output VAT on the second sale to the client, which further increases the cost price should the purchaser not be a VAT vendor. Transfer duty will be payable by the financial institution in terms of the provisions contained in the Transfer Duty Act.

[19] Section 1.
[20] *Lategan v Commissioner For Inland Revenue* (1926) 2 SATC 16.
[21] *Commissioner For Inland Revenue v People's Stores (Walvis Bay) (PTY) LTD* (1990) 52 SATC 9.

In order to overcome the challenges above and to level the playing field between Islamic finance and conventional finance the EM 2010 (2010: 51-53) proposes certain deeming provisions for the financial institution. The financial institution is deemed not to be involved in the purchase and sale therefore deemed not to have acquired or disposed the asset (EM, 2010:52). Section 24JA (3)[22] of the SA Income Tax Act contains deeming provisions for a *murabaha* arrangement and no significant changes were made to the deeming provisions as set in out in the EM 2010 (2010: 54) however in the TLAA 2011 the term 'bank' is replaced by the term 'financier' thus broadening the scope of the deeming provision. As per section 24 JA (3) (a) of the SA Income Tax Act, the financial institution is deemed not to have acquired or disposed of the asset under the *shariah* arrangement.

A similar amendment is proposed to the VAT Act, where the bank is deemed not to be involved with the purchase or sale of the asset, i.e. the bank is deemed not to have acquired or supplied the asset in a *murabaha* arrangement (EM, 2010:52). To accommodate a *murabaha* arrangement the TLAA 2010 (2010:168) includes an amendment to the VAT Act under section 8A(1)[23], which includes the deeming provisions as stipulated in the EM 2010 (2010: 52). Thus for VAT purposes the acquisition of an interest in the underlying asset by the financial institution and the resale of that asset to the client is ignored. The mark-up that is received by the financial institution is deemed by section 8A (2) (c) to be an exempt financial service.

To avoid double transfer duty as per the Transfer Duty Act or Securities Transfer Tax as per the Securities Transfer Tax Act, 25 of 2007 (referred to as 'Securities Transfer Tax Act[24]'), there is a deeming provision contained in the EM 2010 (2010: 52-53) whereby the financial institution is deemed not to be involved with the purchase or sale of the asset and in the case of a *murabaha* between a CIS and a financial institution, the CIS is deemed not to have acquired beneficial ownership in the securities that were acquired by the CIS for the benefit of the financial institution. The tax implications between a *murabaha* arrangement and a conventional loan will then be equal. Section 3A (2)[25] has been included in the Transfer Duty Act and section 8A[26] has

[22] Although the effective date of these sections coming into force is set at 1 January 2013, the Act which enables this had not been promulgated at time of writing.
[23] *Ibid*.
[24] Securities Transfer Tax is payable on the transfer of securities.
[25] *Ibid.*
[26] *Ibid.*

been included in the Securities Transfer Tax Act to accommodate *murabaha* arrangements. The impact of this section is to achieve what was set out in the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (South Africa, 2010: 52-53), that is to alleviate the issue of transfer duty being levied twice on the financing of the same fixed property, first when the financial institution purchases the property and then again on the re-sale by the financial institutions to the client of the same underlying asset, thus the financial institution is deemed not to have acquired the property in a *murabaha* arrangement. An amendment was made to this section in the TLAA 2011 to broaden the scope of the deeming provision and the term 'bank' is replaced by the term 'financier'. Similarly, the provisions contained in section 8A of the Securities Transfer Tax Act deems that, in a *murabaha* arrangement between a CIS and a financial institution, the CIS is deemed not to have acquired beneficial ownership of the security, thus implying that the financial institution will be the beneficial owner.

TAX IMPLICATIONS FOR THE SELLER

The original seller will have CGT implications in terms of the 8th Schedule of the SA Income Tax Act, provided that the asset was held as a capital asset. The tax implications for the seller in a *murabaha* arrangement are similar to that of a conventional financing arrangement.

TAX IMPLICATIONS FOR THE PURCHASER (CLIENT)

Without the proposed changes to the SA Income Tax Act, the purchaser in a *murabaha* arrangement will be at a disadvantage in comparison to conventional finance. For example if a business desires to purchase a delivery vehicle with a cost price of R70 000 and obtains a conventional loan of R85 000 over a period of three years. With conventional finance, on acquisition of an asset the purchaser becomes the owner and can claim capital allowances and the amount in excess of the capital (interest) if these expenses are incurred in the production of income (within the realm of provisions in the SA Income Tax Act). The interest expense of R15 000 will be spread over the period of the financial arrangement, in this case three years and allowed as a deduction in terms of section 24J of the SA Income Tax Act. The business can then claim wear and tear allowances on the R70 000 cost price spread over a period of years as prescribed by the SA Income Tax Act. If we now consider the tax implications for the same transaction under the Islamic financial system in the case of a *murabaha* arrangement without the proposed special tax amendments in South Africa, the cost price to the business would be

R85 000 and thus they would be entitled to claim wear and tear allowances on the R85 000 cost price spread over a period of years as prescribed by the SA Income Tax Act. In essence capital allowances are calculated on the 'second' sale (sale price charged by the financial institution). No interest deduction will be allowed in terms of the SA Income Tax to the purchaser as there is no interest involved in Islamic financial products. In essence the R85 000 will be allowed as a deduction over a period of time, however the timing of the R15 000 deduction will be different. With a conventional loan the R15 000 is considered to be interest and is allowed as a deduction in terms of section 24J of the SA Income Tax Act whereas in a *murabaha* financing arrangement the R15 000 will be added to the cost of the asset and wear and tear can be claimed in terms of the provisions of the SA Income Tax Act. Transfer duty will be payable again, this time by the purchaser in terms of the provisions contained in the Transfer Duty Act. Therefore, we get two different tax allowances between conventional and Islamic finance.

In order to have equity between conventional and Islamic finance the proposed changes in the EM 2010 (2010: 52) to the SA Income Tax Act, include that the client (purchaser) is deemed to acquire the property from the seller directly with two further rules regarding the amount and timing. The amount is equal to the consideration payable by the bank to the seller, i.e. the amount of the 'first' sale (EM, 2010: 52).The client is deemed to have acquired the asset at the time that the seller disposes of the asset (EM, 2010: 52). The proposed changes to the VAT Act in the EM 2010 (2010: 52) similarly deems the client to be acquiring the asset directly from the seller for an amount equal to the consideration payable by the bank or CIS to the seller and to have acquired the property at the time that the seller supplies the property.

The mark up on the sale by the bank is deemed to be interest (EM, 2010: 52). In order to achieve this it is explained in the EM 2010 (2010: 52) that the SA Income Tax Act will deem the *murabaha* arrangement to qualify as a section 24 J 'instrument'; the mark up to constitute the 'premium payable or receivable' (thereby qualifying as section 24J 'interest'); and the consideration payable by the bank to the seller to constitute the 'issue price' (thereby taken into account as a section 24J 'initial amount'). Section 24JA (3)[27] of the SA Income Tax Act sets out the deeming provisions relating to a *murabaha* arrangement and no significant changes were made to these provisions as set in out in the EM 2010 (2010: 51-52). Section 24JA (3) (b) of the

[27] *Ibid*.

SA Income Tax Act sets out the deeming provisions, that in summary states for income tax purposes that the client is deemed to acquire the underlying asset from the seller for a consideration equal to the amount paid by the financial institution and the time of acquisition is deemed to be at the time that the finance provider acquired the asset from the seller. Section 24JA (3) (c), (d) & (e) of the SA Income Tax Act deems a *murabaha* arrangement to be an 'instrument' for the purpose of section 24J of the SA Income Tax Act, in addition in a *murabaha* arrangement the mark up that is charged by the financial institution to the client is deemed to be the 'premium paid' for the purpose of section 24J of the SA Income Tax Act and lastly the amount that the finance provider pays to the seller of the underlying asset is deemed to be the 'issue price' for the purpose of Section 24J of the SA Income Tax Act.

The proposed change to the VAT Act in the EM 2010 (2010: 52) similarly deems the mark up differential to be interest. In terms of section 2 of the VAT Act interest is deemed to be an exempt financial service. However if the bank is providing management services the financial services treatment of VAT will not apply to that extent (EM, 2010:52). To accommodate a *murabaha* arrangement the TLAA 2010 (2010:168) includes an amendment to the VAT Act under section 8A(1), which includes the deeming provisions as stipulated in the EM 2010 (2010: 52). Thus for VAT purposes the client is deemed to acquire the asset for the amount equal to the amount payable by the financial institution to the seller and it is further deemed to be at the time that the seller divested interest in the asset to the financial institution.

The proposed amendments in the EM 2010 (2010: 52-53) further include amendments to the Transfer Duty Act and Securities Transfer Tax Act as follows:

> "For purposes of Securities Transfer Tax a murabaha between a CIS and a bank the CIS is deemed not to have acquired beneficial ownership of the securities which were acquired by the CIS for the benefit of the bank.
>
> i. The bank is deemed not to be involved with the purchase or sale of the property. This treatment means that the bank is deemed not to have undertaken an acquisition of the property that is the object of the murabaha arrangement.

ii. The client is deemed to be acquiring property directly from the seller: (a) for an amount equal to the consideration payable by the bank to the seller, and (b) to have acquired the property at the time that the seller disposes of the property."

The above mentioned principles will also apply to a CIS in respect of Securities Transfer Tax Act (EM, 2010:52). Section 3A (2)[28] has been included in the Transfer Duty Act and section 8A[29] has been included in the Securities Transfer Tax Act to accommodate *murabaha* arrangements. The impact of this section is to achieve what was set out in the EM 2010 (2010: 52-53), that is to alleviate the issue of transfer duty being levied twice on the financing of the same fixed property. The deeming provision contained in section 3A (2) of the Transfer Duty Act has the impact that the client is deemed to have acquired the fixed property at the amount that the financial institution paid for it and at the time the financial institution acquired the fixed property, therefore transfer duty will only be payable once by the client. Similarly, the provisions contained in section 8A of the Securities Transfer Tax Act in a *murabaha* arrangement between a CIS and a financial institution is that the CIS is deemed not to have acquired beneficial ownership of the security (EM, 2010:52).

CONLUSION

Section 24JA (1) of the SA Income Tax Act defines a *murabaha* arrangement as follows:

"means a sharia arrangement between a financier and a client of that financier, one of which is a bank, whereby-

(a) the financier will acquire an asset from a third party (the seller) for the benefit of the client on such terms and conditions as are agreed upon between the client and the seller;

(b) the client –

(i) will acquire the asset from the financier within 180 days after the acquisition of the asset by the financier contemplated in paragraph (a); and

(ii) agrees to pay to the financier a total amount that –

[28] *Ibid*.
[29] *Ibid*.

(aa) exceeds the amount payable by the financier to the seller as consideration to acquire the asset;

(bb) is calculated with reference to the consideration payable by the financier to the seller in combination with the duration of the sharia arrangement; and

(cc) may not exceed the amount agreed upon between the financier and the client when the sharia arrangement is entered into; and

(c) no amount is received by or accrued to the financier in respect of that asset other than the amount contemplated in paragraph *(b)* (ii)."

The TLAA 2011 extends the scope of the *murabaha* arrangement beyond natural persons to cater for all legal entities. The term 'bank' (TLAA 2010) is replaced by the term 'financier' thus broadening the scope of the deeming provision. The amendments thus create a viable alternative to both natural persons and legal entities that wish to enter into a *murabaha* arrangement. Although the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (South Africa, 2011: 69) proposed the period of 30 days for the sale to be extended to a 12 month period, section 24JA (1) of the SA Income Tax Act specifies the period for the client to acquire the asset from the financier within 180 days after the acquisition of the asset by the financier. It was recommended to the Standing Committee of Finance that the period be dropped since no period is stipulated in *shariah* however the rule was designed to conform with conventional finance in terms of where the financial institution quickly transfers the asset to the client, it also further clarified that the period will be determined with reference to the date of disposal which is the date of the agreement and not relating to the date of registration which is usually outside the parties control (South Africa, 2010:15). A further addition to section 24J (A)[30] of the SA Income Tax Act is paragraph (c) which specifies that no amount, other than the total amount referred to in paragraph (*b*) (ii), is received or accrues to the financier in respect of that asset. The deeming provisions for a *murabaha* arrangement are such that it has similar tax effects as a conventional financing arrangement. Thus the overall proposed tax treatment for a *murabaha* in a financing arrangement clearly has a similar tax effect as that of a conventional loan to acquire an asset.

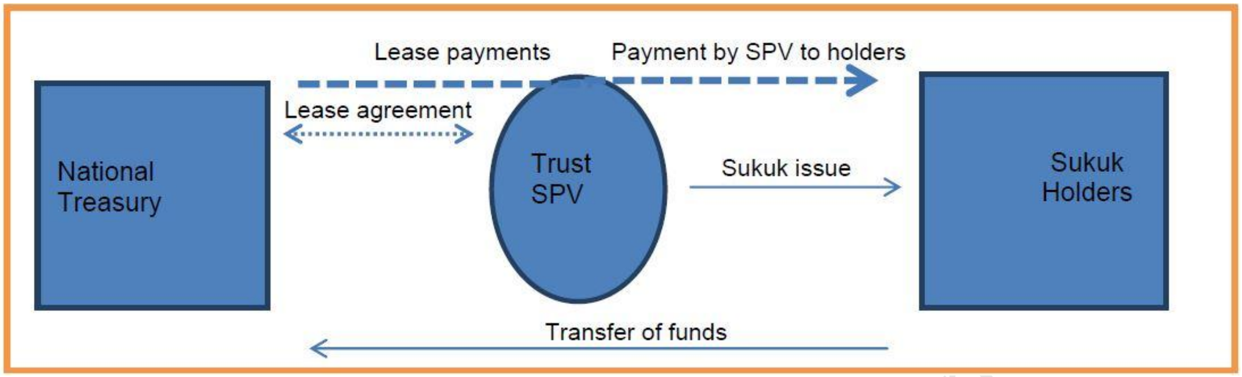
[30] *Ibid*.

3.1.4 SUKUK IJARAH

A simple illustration of a *sukuk* issue clarifies the principles of a *sukuk*. Assume an entity wants to acquire an asset however does not have the resources for the purchase. The entity will issue *sukuk* certificates and purchase the asset with the funds raised from the issuance of the *sukuk* certificates. Together with the issuance of the *sukuk*, the entity which is the *sukuk* issuer commits to repurchase the asset at a specified time. The asset is thus owned by the *sukuk* holders and then leased to the entity. The *sukuk* holder earns rental from its investment in the *sukuk* (see discussion in 2.2.4 and 2.3.4). The *sukuk* thereby is similar to a bond, in a sense that it provides finance to the issuer and provides regular payments to the investor, however the characteristics of the *sukuk* are such that it does not infringe on the principles of *shariah.* In principle, with a *sukuk ijarah* finance is raised without debt being created as the lease of an asset does not involve a debt claim.

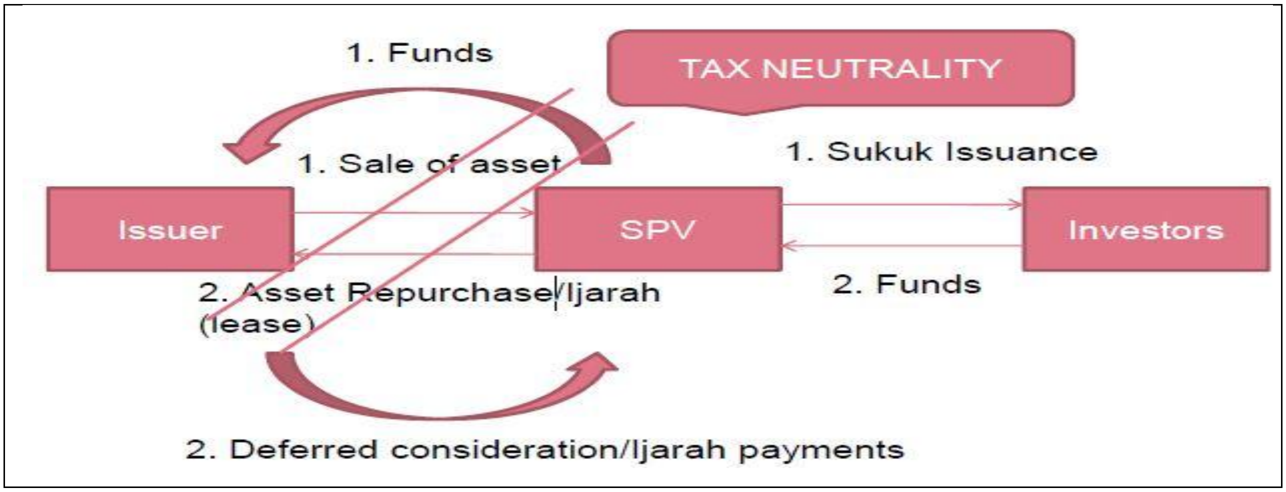
In other instances a *sukuk* issue can be utilised to raise finance by issuing certificates in an asset that the entity already owns, in that case the entity creates a special purpose vehicle (referred to as 'SPV'). The entity acts as a conduit and the asset is transferred to the SPV and the *sukuk* holders hold certificates in the SPV. The entity then leases the asset back and makes lease payments to the SPV which in turn will pay the *sukuk* holders. At a specified period the originator purchases the asset back from the SPV. The structure of the *sukuk* creates adverse tax effects in terms of the SA Income Tax Act for all parties involved namely the originator, the SPV and the holder. In this structure there are two sales of the same asset and if the asset is immovable property the transaction results in transfer duties payable twice on the same immovable property in terms of the Transfer Duty Act. The value of the immovable property may increase between the first and second sale which may result in a taxable capital gain for the purposes of CGT in terms of the 8th Schedule of the SA Income Tax Act. The SPV will be taxed on the rental income in terms of the SA Income Tax Act, which in turn is distributed to the *sukuk* holders. The *sukuk* holders will then be prejudiced since they will be taxed on amounts that have already been taxed by the SPV.

The South African Government intends on launching the first *sukuk,* often dubbed as an Islamic bond, in the form of an *ijarah* financing arrangement. An *ijarah* is similar to a finance lease in conventional financing. The SA Income Tax Act contains anti-avoidance rules relating to finance leases. The proposed *sukuk ijarah* is structurally envisaged by National Treasury as depicted in the EM 2011 (2011: 72) as follows:



In the first step National Treasury identifies the immovable property which is owned by the government for the *sukuk* issue. In step two the beneficial ownership or usufruct of the identified immovable property is transferred to the SPV, in addition investors known as the *sukuk* holders will provide funds to the SPV; these funds will be transferred to National Treasury in exchange for beneficial ownership or usufruct in the immovable property. Step 3 involves National Treasury simultaneously leasing back the beneficial ownership or usufruct for a specified period of time and the lease payments by National Treasury to the SPV will be allocated to investors (*sukuk* holders) after deducting an administration service fee. The basis for the lease charge will be the market related cost of funding provided by the investors. The end of the lease period brings about step 4 which involves National Treasury repurchasing the beneficial interest or usufruct from the SPV at the initial cost to the SPV, thus the repurchase price effectively acts as the repayment of capital at the specified period of time to the *sukuk* holders.

The EM 2011 (2011: 72) further emphasises that the overall arrangement must be sanctioned by Islamic scholars to ensure compliance to *shariah*. South Africa aims to align the tax treatment of a Government *sukuk* with that of a Government bond, which ultimately will result in the rentals earned in a *sukuk ijarah* to be treated as interest. Tax neutrality can be achieved in a *sukuk ijarah* and is depicted in the following diagram by Abrahams & Osman (2010: Online):



TAX IMPLICATIONS - STEP 1 & 2

Step 1 involves the identification of the immovable property by National Treasury only and thus at this stage will not have tax consequences. Transfer of the beneficial ownership of immovable property by National Treasury to the SPV may trigger a disposal and result in capital gains or losses for the purposes of CGT in terms of the 8th Schedule of the SA Income Tax Act. The SPV will be liable for transfer duties on acquisition of the immovable property from National Treasury. The proposed adjustments to the SA Income Tax Act to eliminate adverse tax consequences for this step as set out in the EM 2011 (2011: 72) provides that the deemed sale by Government to the SPV will be ignored for income tax purposes thus eliminating any depreciation and asset related issues that otherwise would arise. Similarly proposals have been made for indirect taxes, in this step the proposal provides that any potential transfer duties that are applicable with the acquisition by the SPV of the immovable property from National Treasury will be disregarded and to eradicate any potential VAT implications for the SPV, the SPV is deemed not to be an 'enterprise' as defined by the VAT Act and thus eliminates the SPV from being a VAT vendor which ultimately eliminates the possible VAT implications upon the re-purchase of the immovable property. On acquisition of the immovable property by the trust, it will be liable for transfer duty in terms of the Transfer Duty Act. However the proposals contained in the TLAA 2011 (2012:6) negates this effect by including an amendment of section 3A (1) (b) of the Transfer Duty Act to account for a *sukuk*, such that the trust is deemed not to have acquired the asset from the National Treasury.

TAX IMPLICATIONS - STEP 3

National Treasury in step 3 makes lease payments to the SPV and the SPV will be taxed on those amounts in terms of the SA Income Tax Act and the VAT Act. The lease payments received are then distributed to the *sukuk* holders, after deducting an administration service fee and will form part of the *sukuk* holders' income for tax purposes. The proposed adjustments to the SA Income Tax Act to eliminate adverse tax consequences for this step as set out in the EM 2011 (2011: 72), include, that the lease payment on the underlying immovable property that is held by the SPV be taxed in a similar manner as interest for income tax purposes. Since the SPV is acting as a conduit the proposed changes include that the deemed interest earned by the SPV that is distributed to the *sukuk* holders will likewise be deemed to be interest earned in the hands of the *sukuk* holders. This principle is in line with South African case law as established in *Armstrong v Commissioner for Inland Revenue*[31]. In this case it was held that income of a trust retains its identity until it reaches the parties in whose hands it is taxable. The conduit principle applied, i.e. income or capital gain that accrues to the trust retains its nature. The trust is a conduit pipe through which the income flows and income retains its identity in the hands of the beneficiary. Similarly a proposal has been made to eradicate any potential VAT implications for the SPV, the SPV is deemed not to be an 'enterprise' as defined by the VAT Act and thus eliminates the SPV from being a VAT vendor which ultimately eliminates the possible VAT implications on the lease payments received.

TAX IMPLICATIONS - STEP 4

On re-purchase of the immovable property by National Treasury, it would result in transfer duty implications for National Treasury. However National Treasury will not be liable for transfer duty since Government acquisitions of immovable property are exempt from transfer duty. The disposal by the SPV may trigger capital gains or losses for the purposes of CGT in terms of the 8th Schedule of the SA Income Tax Act. The proposed adjustments to the SA Income Tax Act to eliminate adverse tax consequences for this step as set out in the EM 2011 (2011: 72) provides that the repurchase by the Government from the SPV will be ignored for income tax purposes. Similarly a proposal has been made to eradicate any potential VAT implications for the SPV; the

[31] (1938) 10 SATC 1.

SPV is deemed not to be an 'enterprise' as defined by the VAT Act and thus eliminates the SPV from being a VAT vendor which ultimately eliminates the possible VAT implications upon the re-purchase of the immovable property.

CONLUSION

The TLAA 2011(2012:126) sets out the definition of a *sukuk (*the amendment to section 24 J A (1)) as

"a sharia arrangement whereby—

(a) the government of the Republic disposes of an interest in an asset to a trust; and

(b) the disposal of the interest in the asset to the trust by the government is subject to an agreement in terms of which the government undertakes to reacquire on a future date from that trust the interest in the asset disposed of at a cost equal to the cost paid by the trust to the government to obtain the asset.''

This definition provides clarity in terms of what constitutes a *sukuk.* The proposed deemed provisions as set out in the EM 2011 coincide with the deeming provisions contained in the TLAA 2011(2012:128), such that the trust is deemed not to have acquired the asset in a *sukuk* arrangement, the Government is deemed not have disposed or reacquired the asset and the consideration paid by the Government for the use of the asset is deemed to be interest as defined in section 24J(1) of the SA Income Tax Act. In addition the proposed amendments to the VAT Act has been included in the TLAA 2011 (2012:208) such that an addition has been made to the proviso to the definition of the term 'enterprise' and has the effect of excluding any activity by the trust in a *sukuk* arrangement and thus the trust is deemed to be the carrying on of an enterprise. The tax treatment of a *sukuk* in South Africa is thus identical to a conventional bond even though returns for the investors are based on the actual performance of the underlying immovable property.

3.2 CONCLUSION

The qualification criteria set out in the EM 2010 (2010: 54) has been incorporated in the TLAA 2010 (2010: 76), with an additional definition of what constitutes a *shariah* arrangement. A '*sharia arrangement'* is defined in TLAA 2010 (2010: 78) as an arrangement that is open for participation by members of the general public; and presented as compliant with *shariah* law when the members of the general public are invited to participate therein. This definition does not define the concept of whether a product is compliant to *shariah.* As discussed in chapter two there are different schools of thought regarding the permissibility in terms of *shariah* and an expectation cannot be made by the legislative authorities to validate the compliance to *shariah.* The aim of this definition is to ensure that the products are advertised as being compliant to *shariah* law. In the Final Response Document from National Treasury and SARS on the Taxation Laws Amendments Bills, 2010 (South Africa, 2010: 14) the South African Revenue Services (referred to as 'SARS') states in response to a request that the concept of *shariah* compliance should be defined, that *shariah* compliance is self-enforcing due to the reputational risk that would be associated with false advertising. The responsibility of whether a product is *shariah* compliant vests in the *shariah* boards which are made up of *shariah* scholars that are appointed at the institutions that offer Islamic financial products. Another key aspect of this definition is that the tax implications of Islamic financial products are not limited to Muslims, which creates an opportunity for anyone interested to invest in arrangements that are governed by the principles of Islamic finance not to be at a disadvantage. This definition of a '*sharia arrangement'* applies to all arrangements under section 24JA of the SA Income Tax Act, which includes *mudarabah, murabaha* and *sukuk.*

The economic reality of the design of Islamic financial products is similar to conventional finance in a sense that both systems create products to cater for their clients' needs. Islamic financial products are structured in an alternative manner to achieve the financing objective based on the principles of *shariah*. In doing so certain Islamic financial transactions may contrast in form to conventional finance transactions however these transactions may appear to be similar in substance. Thus the tax implication of Islamic financial products should be akin to its conventional finance counterpart. The extent of changes required to countries tax legislation to achieve parity with conventional finance depends on whether a country's tax system gives emphasis to the legal form or the substance of a transaction. Where a country's tax system favours the substance of a transaction, limited amendments to the taxation legislation will be required for Islamic finance products. The substance over form doctrine forms the basis of the anti-avoidance provisions of the South African Tax system. However, the difference between Islamic finance and conventional finance is driven by religious belief and devotion and not relating to tax avoidance (Mann, 2009:1151). Legislative changes are required as a result of the basis of the tax system in South Africa.

In South Africa the legislative changes to the SA Income Tax Act relating to Islamic finance are proposed with the intention of promoting South Africa as the centre of Islamic finance in Africa. These changes are simply to recognise Islamic finance and to ensure that the tax treatment for Islamic financial products is on par with conventional finance. Contained in the tax legislation of South Africa are amendments (effective 1 January 2013 once the Act is promulgated) which include deeming provisions that cater for the principles of Islamic finance. The basis of this chapter was to analyse the consequences of not recognising Islamic financial products from an income tax point and to determine whether the provisions contained in the SA Income Tax are sufficient to ensure parity with conventional finance.

The definitions in section 24JA (1) of the SA Income Tax Act provide clarity as to what is considered to be a *mudarabah*, *diminishing musharaka*, *murabaha* and *sukuk*. The deeming provisions contained in the SA Income Tax Act places these products on an equal footing with comparable conventional finance products since these products achieve a similar economic result in substance. The definition of a *sukuk* only refers to a *shariah* arrangement whereby the Government of the Republic disposes of an asset to a trust, thus placing limitation on the other entities that wish to enter into a *sukuk* arrangement to raise capital from benefiting from the tax parity between a *sukuk* and a conventional bond.

International tax issues will have to be considered with the issuance of a *sukuk* to foreign investors. Currently South Africa does not have withholding tax on interest; however with effect from 1 July 2013 a withholding tax on interest will come into effect at 15% of the amount of interest paid to non-residents, subject to certain exemptions. The withholding tax rate may be reduced by the provisions of a double taxation treaty (TLAA, 2010: 102). Payments made to a foreign *sukuk* holder is not legally a payment of interest and the question then arises if the payment to a foreign *sukuk* holder should be subjected to any withholding taxes. In keeping with the intention of the proposed amendments to the SA Income Tax Act to level the playing field between conventional and Islamic financial transactions the withholding tax should apply to profit earned by foreign *sukuk* holders.

Another area of international tax that will have to be considered is double taxation agreements (referred to as DTA's) since these DTA's were entered into based on the principles of conventional financial transactions. In South Africa, a foreign investor in Islamic financial transactions may not automatically qualify, for example, for a reduced withholding tax rate as a foreign investor in a conventional financial investment. In the Organisation for Economic Co-operation and Development Model Tax convention on Income and on capital of 2010 (referred to as 'OECD Model'), Islamic financial transactions are not recognised and the definition of interest in Article 11(3) is not wide enough to accommodate Islamic financial transactions. Article 11(3) of the OECD Model defines interest as follows:

> "The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

A unique characteristic in Islamic finance is that when funds are received from a client due to penalties levied on a default of payment in a financial arrangement this amount does not represent income of the finance provider in terms of *shariah* and the finance provider has to distribute these funds for charitable purposes. Perhaps a further deduction or alternative incentive should be available to Islamic finance providers for this type of distribution to charitable organisations.

The taxation system in other countries may differ to that in South Africa; however the tax implications for Islamic finance could pose a challenge to any tax system since Islamic financial products are designed within a similar framework to conventional finance. The next chapter focuses on the tax treatment of certain Islamic financial products in the UK and Malaysia with the intention of drawing a conclusion based on the comparisons with the tax treatment in South Africa.

CHAPTER 4

4.1 TAX IMPLICATIONS IN THE UK

Since 2000 the United Kingdom (UK) has actively supported the development of Islamic finance by setting up a work group to investigate the obstacles facing the Islamic financial industry (UK, 2008:10). The Financial Services Authority (referred to as 'FSA') regulates financial services in the UK and their approach to Islamic finance can be summed up as "no obstacles, but no special favours" (McCarthy, 2007: online). The economic effect of Islamic financial products may be similar to their conventional counterparts however the structure of the contracts may be different. Both the UK and South Africa's tax system follows a legal approach where transactions tend to be taxed on the form instead of the economic substance. Where an arm's length loan is granted in the UK by a company, then in broad terms each party to the loan will be taxed on interest receivable or relieve interest payable (Cape, 2010:40). In addition for UK VAT purposes supplies of financial services are exempt and no stamp duty land tax (referred to as 'UK SDLT') arises on entering a loan, making and or receiving payments under a loan transaction and transferring interest in a loan (Cape, 2010:40). The UK tax legislation, like South Africa's thus required specific adaptation to accommodate the principles of Islamic finance in order to alleviate any tax costs that would be favourable or unfavourable to parties in an Islamic financial transaction.

Since 2003, the UK has recognised the need to cater for adaptation of their tax legislation for Islamic finance and introduced changes to level the playing field between Islamic and conventional finance. In 2003 changes were made to the Finance Act 2003, in order to account for *murabaha* sales for individuals' mortgages of UK land and *ijarah* arrangements (Bi, 2010: online). These amendments were to eliminate UK SDLT from being levied twice on the same transaction.

Although there is no mention of Islamic finance or the names of the Islamic financial products in the UK tax legislation, the tax legislation creates a set of definitions that are applicable to Islamic financial products. Regardless of whether a product is *shariah* compliant or not the legislation will apply to any financial arrangement that falls within the definitions (Amin, 2007: online). Overall the approach in the UK to Islamic financial products is such that it brings finance costs within the same tax legislation that applies to interest. The tax legislation in the UK caters for five types of alternative finance arrangements. Amin (2008:8) presents the terminology in the UK tax legislation that links to Islamic financial products in the following table:

Tax law	Islamic finance
Purchase and resale	Murabaha
Deposit	Mudaraba
Profit share agency	Wakala
Diminishing shared ownership	Diminishing musharaka
Alternative finance investment bond	Sukuk

The Finance Act 2005 introduced legislation changes for the purposes of income tax and corporation tax to accommodate the principles of a *purchase and resale* (*murabaha)* arrangement and introduced tax legislation to account for a *deposit* (*mudarabah)* arrangement (Bi, 2010:online). In 2006, the Finance Act 2006 introduced further legislation to account for two more Islamic financial products namely, *profit share agency* arrangements (*wakala)* and *diminishing shared ownership* arrangements *(diminishing musharaka)* and the legislation was also amended to extend the double UK SDLT relief to partnerships and companies (Bi, 2010: online). a*lternative finance investment bonds (sukuk)* was introduced to the tax legislation initially in the Finance Act 2007 and further changes in 2008 and 2009 were made to further accommodate a*lternative finance investment bonds (sukuk)* (Bi, 2010: online).

4.1.1 MUDARABAH

The UK has tax legislation to prevent parties that provide finance to disguise what is in substance equity finance as debt to obtain the benefit of a tax deduction for interest, and the legislation applies to interest paid on "*securities under which the consideration given... is... dependent on the results of the companies business''* (Amin, 2007: online). This provision in the tax legislation will apply to profit paid by the financial institution to the investors in *mudarabah* arrangements and treated as a distribution, however specific legislation has been added to the UK Finance Act such that this provision does not apply to *mudarabah* arrangements.

The UK tax legislation refers to alternative financing arrangements, whereby a *deposit* is equivalent to a *mudarabah* arrangement. In a *mudarabah* transaction the profit paid or credited to the depositor is taxed as an *'alternative finance return'* and treated as if it is payment of interest. In order to qualify within the loan relationships legislation, certain conditions should be satisfied as follows as per the HM Revenue & Customs (referred to as 'HMRC') published manual, Corporate Finance Manual (referred to as 'CFM') 4090 (United Kingdom, 2012: online):

- "A person ('the depositor') deposits money with a 'financial institution'
- The deposit together with money deposited with the financial institution by others is used by the financial institution with a view to producing a profit. For example the financial institution may use the deposits in its own business or invest in third party businesses.
- From time to time the financial institution pays or credits a payment to the depositor in proportion to the amount deposited by him, out of any profit from the use of the money. The amount paid or credited in a period need not necessarily be the amount of profit earned in that period. The financial institution may calculate the alternative finance return to be paid based on the profit earned in a number of previous periods.
- The payments or credits made by the financial institution to the depositor are equivalent in substance to a return made on an investment of money at interest."

Profits paid by the bank to the investor are treated as exempt from VAT in terms of the UK Value Added Tax Act 1994 (referred to as 'UK VATA') (Eisenberg & Nethercott, 2012:4.158).

4.1.2 DIMINISHING MUSHARAKA

In the UK, like in South Africa, the deductibility of rent payable by the ultimate owner to the financial institution in a *diminishing musharaka* arrangement depends on whether the asset is for business or personal use (Amin, 2010:online). However, section 47A of the UK Finance Act provides for *diminishing shared ownership (diminishing musharaka)* arrangements and it states that if the transaction meets the qualification criteria in this section then a portion of the rent paid to the financial institution is treated as interest for both the client and the financial institution (Amin, 2010:online).

The *'alternative finance return'* is treated as interest for tax purposes provided that the following conditions are met: "1) one of the parties must be a financial institution[32] and 2) the arrangements must be of type and nature described in the legislation including that the eventual owner must have the exclusive right to occupy or otherwise use the asset and can be exclusively entitled to the income, profits or gain arising from or attributable to the asset; and 3) the alternative finance return or the profit share return must equate to, in substance, a return on an investment of money at interest" (Australia, 2010:50-51).

The HMRC published manual, CFM 44070 (United Kingdom, 2012: online), further stipulates certain conditions: "1) the first owner and the eventual owner both acquire a beneficial interest in the asset; 2) the eventual owner makes a number of payments to the first owner equal in total to the amount paid by the first owner for its beneficial interest in the asset; and 3) the eventual owner makes 'other payments' to the first owner, over and above the payments made to acquire the first owner's beneficial interest."

The amount of the *'alternative finance return'* is calculated as the difference in the amount paid by the eventual owner to the financial institution and the amount paid by the financial institution for its beneficial interest in the asset. Thus for tax purposes, the total payment exceeding the amount initially contributed by the client to the *diminishing musharaka* arrangement is treated as interest. The amount contributed by the financial institution to acquire its beneficial interest will be treated as if the amount were loaned by it to the eventual owner; in essence the transaction will be treated as a loan relationship between the financial institution and the eventual owner (Cape, 2010:41).

Initially the tax legislation provided exemption for UK SDLT liability to individuals that utilised this form of finance in the stage where payments are made by the customer to the financier, however the financier will require the customer to pay UK SDLT for the acquisition of the property (Hameed, 2007: online). The exemption in the legislation was later amended in 2006 to extend to any customers that are classified as 'persons' for example companies and partnerships (Hameed, 2007: online). The Finance Act 2003 caters for relief to ensure that any increase in the

[32] UK tax legislation defines a financial institution as, "A financial institution includes a bank, a UK building society, a wholly-owned subsidiary of the foregoing, certain persons authorised to carry on consumer credit or hire business in the UK or a non-UK person authorised to take deposits or other repayable funds from the public and grant credit on its own account" (Australia, 2010:50-51).

underlying asset during the period of the *diminishing musharaka* arrangement is not subject to UK SDLT (Butt & Sinha, 2008:25). In December 2006 HMRC issued the VAT Information Sheet 11/06 (United Kingdom, 2006: online), which sets out the UK VAT implications of certain Islamic financial products. This document covers the VAT treatment for acquisition of real estate by utilising a *diminishing musharaka* arrangement as the method of finance. For VAT purposes there are two supplies, namely: 1) gradual sale of the equitable interest in the asset and a lease in the asset. The VAT Information Sheet 11/06 states that the normal rules for property apply and in the case of other assets the normal rules that follow a partial sale and leasing would apply (United Kingdom, 2006: online). Thus the UK legislation enables a *diminishing musharaka* arrangement to be an option, from a tax perspective for a business that wishes to acquire an asset using Islamic finance.

4.1.3 MURABAHA

A *purchase and resale arrangement* (*murabaha*) is an arrangement between two persons where at least one of the parties to the arrangement must be a financial institution and the following conditions should be satisfied as per the HMRC published manual, CFM 44060 (United Kingdom, 2012: online):

- "One person ('the first purchaser') buys an asset and sells it to another person ('the second purchaser').
- The sale must either immediately follow the purchase, or if the first purchase is a financial institution, then the asset must have been purchased by the first purchaser for the purpose of entering into an alternative finance return arrangement. This allows financial institutions that may hold a stock of commodities for the purpose of entering into alternative finance return arrangements to qualify for loan relationship treatment.
- All or part of the sale price paid by the second purchaser is paid after the sale - so there is, in whole or part, deferred sale consideration.
- The sale price paid by the second purchaser is higher than the amount paid by the first purchaser.
- The difference between the sale price paid by the second purchaser and the purchase price of the first purchase equates in substance to the return on an investment of money at interest. A purchase and resale arrangement should, in accordance with GAAP, be presented in the company accounts of the first and second purchasers in the same way as a conventional loan."

The difference between the purchase price and the sale price is treated as a finance return. The effective return which is the difference between the sale price and the purchase price of the asset in a *murabaha* transaction is treated as if they were payments of interest and partial repayments of capital (Amin, 2007: online). The legislation further prescribes that the purchase price payable under this type of arrangement is to be as the principal amount under a loan. If the sale price is paid in full on one day then the *'alternative finance return'* equates to the difference between the sale price that is paid by the second purchaser and the purchase price paid by the first purchaser. However, where the sale price is paid in instalments, each instalment will include an *'alternative finance return'* that is equal to the 'appropriate amount' (Amin, 2007: online). According to the HMRC published manual, CFM 44060, the 'appropriate amount' for each instalment refers to the amount equal to the interest that would have been included in the instalment if:

- "interest had been payable on a loan by the first purchaser of the asset to the second purchaser, equal to the amount paid by the first purchaser for the asset;
- the interest payable on the loan had been equal the excess of the amount paid by the second purchaser over the amount paid by the first purchaser; and
- the instalment was a part payment of the principal and interest that would have been payable on such a loan; and
- the loan was on arm's length terms and accounted for under GAAP" (United Kingdom, 2012 online).

Thus the requirement is that the effective return is apportioned in accordance with generally accepted accounting practice (GAAP) and not apportioned on the straight line basis (Amin, 2007: online). HMRC published manual, CFM 44060 however states that since the loan is at a fixed rate a straight line calculation of interest is acceptable (United Kingdom, 2012: online).

The purchasing of property in the UK generally is subject to UK SDLT. The tax legislation in the UK is such that it prevents UK SDLT from being levied twice on the same transaction, first on purchase of the property by the bank and subsequently on the sale of the property by the bank to the customer. VAT Information Sheet 11/06 (United Kingdom, 2006: online) clarifies the VAT implications for a *murabaha* financing arrangement for goods and property and states that the resale is treated as a credit sale. There are two supplies that are made by the bank, i.e. one of the goods/property and the other the facility to defer payment. The supply of goods will follow the normal liability rules and the 'profit' element will be exempt under the UK VATA.

In essence the eventual owner is taxed as if the original cost of the underlying asset acquired by the financial institution were the amount of a loan granted and the payments made by the eventual owner in excess of that amount will be treated as interest (Cape, 2010:42).

4.1.4 SUKUK IJARAH

The structure of a *sukuk ijarah* has potential adverse UK tax consequences. Multiple tax issues may arise. A *sukuk ijarah* has three transactions in respect of one asset, viz.: 1) the original sale of the asset to the SPV; 2) the lease of the asset by the SPV back to the originator and 3) the re-acquisition of the asset by the originator (Amin, 2011: online). These transactions may have potential UK SDLT or similar taxes relating to the leasing of an asset (Amin, 2011: online). If the value of the asset increases between the first and the second sale, capital gains tax implications may result. The income earned by the SPV will be taxed in terms of section 209(2)(iii) of the Income and Corporations Taxes Act 1988 (referred to as 'UK ICTA') which has the implication that where a return on a debt instrument is dependent upon the results of a company's business the interest return will be treated as a distribution and not a tax deductible expense (Amin, 2007:1). This income will also be taxed in the hands of the *sukuk* holders again.

In 2007 the UK tax law introduced basic legislation for an '*alternative finance investment bond' (sukuk).* In 2008 changes were made to the UK tax law relating to stamp duty to counteract SDLT avoidance schemes (Amin, 2008:7).The aim of the tax legislation amendments is to provide the same tax treatment that applies to a debt instrument.

In order for an arrangement to be considered as an *'alternative finance investment bond'* the UK tax legislation requires that one or more persons pay money to a bond issuer, the bond issuer acquires some assets which will generate income or gains (Amin, 2007:1). Further requirements include that there has to be a fixed period for the arrangement and at the end of this period, the issuer has to undertake to dispose of any bond assets that are left. The issuer will make two sorts of payments to the *sukuk* holders, which in the case of a *sukuk ijarah* will comprise rental and at the end of the term the *sukuk* assets must be disposed of and redemption payment is made to the *sukuk* holder. The legislation further prescribes that the additional payment made to the *sukuk* holders must not exceed a reasonable commercial return on a loan equal to the amount of capital (Amin, 2007:1). Another condition specified in the HMRC published manual, CFM 44140 (United Kingdom: 2012 online), is that the *'alternative finance investment bond'* must be listed on a recognised stock exchange. A final condition is that the *sukuk* be recognised and treated as a financial liability in terms of the International Financial Reporting Standards (IFRS) (Amin, 2007:2).

If a conventional loan specifies that it pays interest at a particular rate then the bond holder has a contractual right to that amount of interest. The difference however with a *sukuk* holder is that the *sukuk* holder is entitled to returns based on actual returns thus the quantum of the payments to the *sukuk* holders is not fixed. Thus the legislation provides for this, as clarified in the HMRC published manual, CFM 44160 wherein it states that although there is flexibility in the quantum of the additional payments, the return must not exceed a reasonable commercial return (United Kingdom: 2012 online).

HMRC published manual, CFM 44240 indicates that the legal position of the trust (SPV) created for the issuance of a *sukuk* does not matter since any trust created is ignored for Corporation Tax purposes (United Kingdom: 2012 online). The tax treatment of an *'alternative finance investment bond'* from the perspective of the *sukuk* issuer is the same as if it were a debt instrument. The additional payments made to the *sukuk* holders are treated as interest for tax purposes and thus may be tax deductible (Amin, 2007:2). The UK tax legislation has the effect such that the *sukuk* issuer continues to beneficially hold the *sukuk* assets and income or gains that arise from the *sukuk* asset are treated as part of the *sukuk* issuer's profits or gains. Following the same principle the *sukuk* issuer is allowed to claim capital allowances while the bond asset is held by the SPV. For tax purposes, the *sukuk* holders are treated as having no legal or beneficial interest in the *sukuk* assets and the *sukuk* holders do not qualify for capital allowance relief. The return paid to the *sukuk* holders is tax deductible in the same manner as interest is paid to bond holders in a conventional bond (Eisenberg & Nethercott, 2012:4.192).

In 2009 the treatment for a *sukuk* was amended such that it removed capital gains tax and UK SDLT from the issue, transfer and redemption of a *sukuk* (Eisenberg & Nethercott, 2012:4.195). The legislation amendment further provides tax relief on capital gains that would result in respect of the transfer of land to and from the SPV and the *sukuk* issuer. The sale of certificates issued with a *sukuk* where the underlying assets are UK land and buildings are exempt from UK SDLT.

The sale of the asset to the SPV is treated as a VAT free transfer of a going concern provided that the asset capable of being a separate operation and where it isn't a separate operation the normal VAT rules will be applicable (Eisenberg & Nethercott, 2012:4.197). The SPV will be liable for VAT purposes on the income produced by the SPV based on the nature and use of the asset, this treatment is such that the normal VAT rules will apply (Eisenberg & Nethercott, 2012:4.198). The sale of the *sukuk* asset may qualify as VAT free transfer of a going concern and the VAT implications will depend on the type of asset (Eisenberg & Nethercott, 2012:4.199).

4.2 MALAYSIA'S TAX INCENTIVES

Malaysia has developed a strong Islamic financial industry over the years. Its development is clearly visible in the country's financial system. Malaysia has a dual financial system, section 27 of the Central Bank Act 2009 (Act 701) states that the financial system in Malaysia shall consist of the conventional financial system and the Islamic financial system (Trakic, 2012:17). Malaysia has two *shariah* governing committees namely the National Shariah Advisory Council at the Bank Negara Malaysia and the Shariah committee at the Islamic Financial institution. Malaysia issued its first global sovereign *sukuk* in 2003 and presently Malaysia is the world's largest issuer of *sukuks* (Krasica & Nowak, 2012:3). Malaysia has had success with Islamic finance and in 2011 the '2011-2020 Financial Sector Blueprint' was issued. This blueprint has "reinforced the government's initiatives to establish Malaysia as the international Islamic finance centre through the development of innovative Islamic financial instruments, further mobilization of international Islamic financial flows, and strengthening the legal and *Shariah* frameworks" (Krasica & Nowak, 2012:5).

With the intention of achieving tax neutrality between Islamic and conventional finance changes were provided in the Laws of Malaysia Act 53 Income Tax Act 1967 (referred to as 'the Malaysian Income Tax Act') and Stamp Act (1949) (referred to as the 'Malaysian Stamp Act') as early as 2001 (Krasica & Nowak, 2012:6). Section 2(7) of the Malaysian Income Tax Act states, "Any reference in this Act to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the *Syariah*." Section 2(8) of the Malaysian Income Tax Act has the impact of ignoring the sale such that tax neutrality can be achieved with Islamic financial products by stating that:

> "… any reference in this Act to the disposal of an asset or a lease shall exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank or the Securities Commission or LOFSA [Labuan Offshore Financial Services Authority], as a scheme which is in accordance with the principles of Syariah where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other schemes of financing."

The Malaysian Income Tax Act treats 'gains or profits' in Islamic financial products similar to interest thus resulting in the taxability and deductibility of 'gains or profits' the same as interest in conventional financial products.

With the intention of establishing Malaysia as an international Islamic financial hub tax incentives were incorporated for Islamic finance in 2006. Some of these incentives were granted to encourage foreign investment. These incentives include the following (Krasica & Nowak, 2012: 6):

- "A 10 year exemption was in place for Islamic banks and Islamic insurance companies on income derived from business conducted in foreign currencies (including transactions with Malaysian residents).
- Tax exemption for profits derived from Sukuk.
- 10-year income tax exemption[33] for domestic and foreign fund managers who manage Islamic funds for foreign investors.
- 3-year stamp duty exemption of 20 percent on instruments related to Islamic financing.
- Tax deductions on expenses incurred in establishing an Islamic stock broking firm.
- Tax exemption on profits paid by licensed Islamic banks in Malaysia to non-resident customers."

These incentives have contributed to the inflow of foreign investment. In mid-2011 foreign holdings of Malaysia's sovereign debt were at 24.6 percent of total government bonds and Islamic investments account for approximately 40 percent of sovereign and corporate bond issuances (Krasica & Nowak, 2012: 7-8). According to the 2012 Investment Climate Statement – Malaysia (United States, 2012: online), tax relief is furthermore provided for Islamic finance

[33] The tax emption is based on fees received from the management of Islamic funds (United States, 2012: online).

studies where expatriate experts in the Islamic finance field are exempted from paying Malaysian income tax.

4.3 CONCLUSION

In comparison to South Africa, the tax regime in the UK has been amended without reference to religion. The aim in the UK was to adapt the legislation to create freestanding definitions which are neutral to religious beliefs but at the same time to accommodate Islamic finance (Amin, 2007: online). The South African Government views the non-inclusion of the reference to Islamic finance as too risky from an avoidance perspective (South Africa, 2010:14). South Africa's view is that the intention of the inclusion of Islamic finance is simply to place Islamic financial arrangements on par with conventional financial arrangements (South Africa, 2010:14). To avoid bias, the provisions relating to Islamic finance in the SA Income Tax Act are applicable not only to people of the Islamic faith but to any client that utilises Islamic financial arrangements. In the UK tax legislation additional payments in Islamic financial transactions are not deemed to be interest although treated in the same manner as interest.

In comparison to the proposed amendments to the SA Income Tax Act which only provides for tax relief on the issuance of a government issue of a *sukuk* the UK tax legislation has amendments to account for an individual or entity that wishes to raise finance via a *sukuk*. Amendments to South Africa tax legislation should be considered to allow individuals or entities to also issue a *sukuk* (currently the proposal is for National Treasury to issue a *sukuk*) and tax relief should be provided in the Transfer Duty Act for any potential transfer duty tax. The proposed tax relief for VAT and Income Tax that relates to a *sukuk* issue should also extend to individuals or entities.

For tax relief on Islamic financial transactions in the UK one party has to be a financial institution which is a limiting factor and does not create an equal playing field with conventional finance. South Africa's proposed tax amendments are not limited to Islamic financial transactions with financial institutions in a *murabaha* financial arrangement which could widen the interest and scope of investment in this type of arrangement. However, the scope is limited to financial institutions in a *diminishing musharaka* financial arrangement.

South Africa does not have specific proposals to cater for international tax aspects relating to Islamic financial transactions. In the UK the definition of 'permanent establishment' in the Finance Act 2003[34] was amended such that where a non-resident company is party to an Islamic financial arrangement, that company is not treated as creating a UK permanent establishment purely by entering into an Islamic financial arrangement (Amin, 2007: online).

The amendments to cater for Islamic finance in the UK differs to South Africa; however both South Africa and the UK have designed mechanisms based on its own current tax legislation in order to alleviate the differences between the tax treatment of conventional and Islamic financial products. Both UK and South Africa have the same aim regarding the tax consequences of Islamic financial products whereby ultimately the profit element is treated as interest and the adverse tax consequences that arise with Islamic financial products are eliminated. UK has been a pioneer in tax amendments relating to Islamic financial transactions and for South Africa to be established as a hub of Islamic finance in the African continent it can incorporate the extent of changes made in the UK as identified above.

In Malaysia, both Muslims and non-Muslims utilise Islamic finance and the majority of Islamic finance customers are non-Muslims (Krasica & Nowak, 2012:4). Factors that could influence investment in Islamic finance in Malaysia can be a combination of the ethical principles that Islamic finance is based on and the extent of its government's commitment to developing the industry. For example the tax implications of Islamic financial transactions go beyond providing merely tax neutrality. Malaysia's growth in foreign investment in Islamic finance can be attributable to the attractive tax incentives in the country. Foreign investors that wish to invest, based on the principles of Islamic finance may choose Malaysia over South Africa due to the tax incentives available in Malaysia. Should the South African government wish to rapidly attract foreign investment in Islamic finance, South Africa can in addition to achieving tax neutrality provide for tax incentives for parties involved in Islamic financial transactions.

[34] Section 148.

CHAPTER 5

5.1 CONCLUSION

Globally the Islamic finance industry is growing at a rapid rate. Islamic finance, which is based on *shariah,* has its own underlying principles and practices which create an economic system which is based on justice and equity. The Islamic financial model has key underlying differences in comparison to conventional finance which include the impermissibility of interest; prohibition of certain industries; *gharar* (excessive uncertainty) and *maysir* (gambling or speculation). Although the structure of Islamic financial products is different to conventional finance, the aim of both options is ultimately to provide finance.

Islamic finance is clearly at an embryonic stage in South Africa however it does provide an alternative method of finance not only to Muslims but to people who wish to invest in the principles of *shariah.* The South African banking industry has evolved and the majority of the well-known banks have windows that provide Islamic financial products. Islamic financial products are currently taxed in South Africa based on their legal form and thus it places the tax implications of Islamic financial products at a disadvantage in comparison to conventional financial products. For South Africa to be a part of this growing industry the South African government has initiated proposed tax amendments to the SA Income Tax Act with the idea of aligning the tax implications of Islamic financial products with its conventional finance counterpart.

The focal part of this study was to explain the proposed amendments to the SA Income Tax Act that are relevant to Islamic finance to evaluate whether these proposed tax amendments place Islamic financial instruments on an equal footing with its conventional finance counterpart. The detailed comparisons are cited in chapter 3 of this study. Ultimately, the proposed tax amendments contain deeming provisions that have the impact of disregarding the legal form of the contracts and places emphasis on the economic substance of the Islamic financial product. However, for a *sukuk* there is only tax parity when the government issues this type of product, this could deter other parties from issuing a *sukuk.* Certain international tax issues relating to Islamic finance have not yet been considered by the South African government. The introduction of the new withholding taxes in July 2013 on interest paid to non-residents poses a question as to whether the withholding tax will be applicable to profit earned on Islamic financial products by non-residents. Technically to achieve parity, the withholding tax on interest should also apply to profit earned on Islamic financial products. It is hoped that this study provides clarification on the principles of Islamic finance and the proposed tax implications of Islamic financial products for both investors (foreign and local) and financial institutions in comparison to its conventional finance counterpart.

Countries like the UK and Malaysia have had significant growth in Islamic finance and have already implemented changes to their tax regime. The main focus ultimately in both countries is to place the tax implications of Islamic finance on an equal footing with conventional finance. The UK followed the approach of providing tax parity between the two financial methods and providing no special favours whereas Malaysia went a step further and provided parity and tax incentives for Islamic financial products. The Islamic finance tax legislation in the UK and the Islamic finance tax incentives that are granted in Malaysia are cited in detail in chapter 4 of this study. In comparison to South Africa the UK has provided for certain potential international tax implications relating to Islamic finance which is critical for South Africa to consider and incorporate into its tax legislation. With the South African government's aim of promoting South Africa as a hub for Islamic finance in Africa, an additional measure can be taken into account to achieve this aim by providing tax incentives for Islamic finance should South Africa desire to compete with countries such as Malaysia.

This study provides investors and financial institutions with a greater insight to the fundamentals of Islamic finance and provides clarifications of the proposed tax implications relating to Islamic finance in South Africa in comparison to the selected countries. By incorporating the findings of this study together with the proposed current Islamic finance tax amendments, South Africa will be in an enhanced position in achieving its aim of establishing itself as the hub of Islamic finance in Africa.

GLOSSARY OF ARABIC TERMS

Bai' Mu'ajjal: Instalment sale (sale where the payment is deferred).

Diminishing Musharaka: Joint ownership of assets, where the buyer purchases units of the other partner over a period of time to acquire total ownership of that asset.

Fiqh: Refers to the human understanding and knowledge of *shariah*

Fiqh al mu'aamalaat: Islamic commercial law

Gharar: Excessive uncertainty.

Hadith: A narration of an act or saying of the Prophet Muhammed (Peace and blessings be upon him).

Haram: Unlawful and forbidden explicitly by the *Holy Qur'an* and *Sunnah.*

Holy Qur'an: The religious book of Islam that Muslims believe to be the literal word of God.

Ijarah (lease): A lessor leases or transfers ownership of the asset to the lessee for a specified period in exchange for a pre-arranged consideration.

Istisna (work in process): A contract where the seller agrees to construct or manufacture the asset to be sold. This type of product is mostly used to finance construction and development.

Maysir: Gambling or speculation

Mudarib: Entrepreneur in a *mudarabah* contract.

Mudarabah: It's a form of investment partnership whereby the investor provides capital to the entrepreneur. Profits are shared on a pre-agreed ratio at the beginning of the business activity while losses are borne by the investor alone.

Murabaha (cost plus financing): This method of financing entails one entity purchasing the asset, adding a fixed mark-up profit and then re-selling the asset. The profit mark- up, other costs and repayment (usually in instalments) are specified in the contract.

Musharaka: A joint venture or partnership to undertake economic activity.

Rabb-ul-mal: Refers to the party that provides capital in a *mudarabah* contract.

Riba: Interest, earning money on money.

Salam (pre-paid transaction): A transaction that involves making payment now for a commodity and delivery takes place at a later agreed time.

Shariah: Islamic law that is derived from the *Holy Qur'an* and *Sunnah*.

Sunnah: Is the way of life of the Prophet Muhammed (Peace and blessings be upon him), his manner of conduct in his daily life and his application and his interpretation by word and action of the message of the *Holy Qur'an.*

Sukuk: Is an Islamic investment certificate where the holders of the certificate share in the ownership of the assets and risk and rewards. The *sukuk* is also dubbed as an Islamic bond.

Takaful (Islamic insurance): Refers to the collective pooling of resources of members in order to provide support to members as required. This type of insurance is based on *shariah* law and is an alternative to conventional insurance which comprises of elements that are impermissible to Muslims.

Wakala: An agency agreement.

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